South Carolina Law Review

Volume 21 | Issue 5 Article 2

1969

# Impact of Barchris: An Analysis of the Practical and Legal Implications of Escott v. Barchris Construction Corp.--Section 11 Revisited

Mark A. Evans

# THE IMPACT OF BARCHRIS: AN ANALYSIS OF THE PRACTICAL AND LEGAL IMPLICATIONS OF ESCOTT v. BARCHRIS CONSTRUCTION CORP.— SECTION 11 REVISITED

MARK A. EVANS*

*Scire leges non hoc est verba earum tenere sid vim ac potestatem.*[1]

## INTRODUCTION

### BARCHRIS AND THE SECTION 11 PHENOMENON

On March 29, 1968, Judge McLean, of the United States District Court, Southern District of New York, handed down the decision in *Escott v. BarChris Construction Corporation*.[2] This was, in essense, the first case to deal substantially with the "due diligence" defenses afforded the defendants in a civil action against them under section 11 of the Securities Act of 1933,[3] for damages sustained as a result of false statements or material omissions in a registration statement[4] or prospectus.[5]

* J.D., University of Miami School of Law; L.L.M., Harvard Law School; Associate, Loeb and Loeb, Los Angeles; member of Florida and California Bars.

1. "To know the laws is not merely to understand the words, but their force and effect." JUSTINIAN, DIGEST.
2. 283 F. Supp. 643 (S.D.N.Y. 1968). The case was a spurious class action by buyers of debentures against (1) the corporation which issued the debentures, (2) signers of the registration statement for the debentures, (3) the underwriters, and (4) the corporation's auditor for damages sustained as a result of false statements and material omissions in the prospectus contained in the registration statement. Finding that the prospectus contained material falsities and omissions, the court held that the defendants failed to sustain their burden of proving the due diligence defenses asserted, or that the damage suffered by each plaintiff had been caused by factors other than the material falsities or omissions. The decision was limited to a finding concerning the immediate defendants under the section 11 action, and reserved ruling on the cross-claims and on the issue of damages. *Id.* at 652. The court denied defendants' motions to dismiss, and the case was settled before further judicial announcement.
3. 15 U.S.C. § 77k (1964); hereinafter referred to as the Act.
4. Section 5 of the Act, simplistically stated, provides that whenever an issuer wishes to distribute securities to the public it must register the offering with the Securities Exchange Commission (hereinafter referred to as the SEC), U.S.C. § 77e (1964). Section 6 describes the requirements of registration, 15 U.S.C. § 77f (1964), and the form most commonly used is SEC Form S-1, "Registration Statement Under the Securities Act of 1933" (hereinafter referred to as S-1).
5. The prospectus, which is initially attached to the registration statement, is a document which is circulated to the public to elicit sale of the securities

The magnitude of the decision can best be measured by two reactions: that of the investment community (those involved directly in the public offering), and that of the purchasing public. Initially, and of signal importance, is the fact that although the decision is that of a lower court, and not binding upon the same or other district courts, let alone the appellate divisions, it has had an immediate and widespread impact upon members of the bar within and without the securities field, accountants, investment bankers, and others connected with public offerings. Secondly, and obviously the phoenix of the above reaction, is the potential awakening of the public to the ready availability of section 11 as a suitable vehicle to recovery.

Section 11, although originally designated as the "teeth" of the Act,[6] the provision that would secure "truth in securities",[7] has experienced relatively little activity and has come to be known euphuistically as the "neglected child" of the civil remedial sections.[8]

Some causal factors have been suggested to explain the paucity phenomenon of section 11,[9] such as the exemplary task con-

offered. It contains, among various other things, a description of the type of securities offered, the terms of the offer, a general description of the business of the issuer, its financial position, and a description of the various officers and directors. 15 U.S.C. § 77j (1964).

6. *See* Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933); Landis, Address before the N.Y. State Society of Certified Public Accts., Wall Street Journal, Nov. 1, 1933, at 10.

7. *Id.*

8. As indicated by Professor Loss only 13 cases were reported in the first 29 years of the Act, and in the subsequent six years there were only 17 more reported cases. It is interesting to note that judgment for the plaintiff was awarded in only two of these cases, with six judicially approved settlements being reported. Mention is also made of the fact that the two recoveries came out of an estimated 18,000 filed registration statements. *See* 6 Loss, SECURITIES REGULATION 3820 (1969), and 3 Loss, SECURITIES REGULATION 1691 (1961).

9. The experts are in disagreement as to the cause or causes of the section 11 phenomenon. One proposition set forth requires us to view retrospectively a theory of section 11 posed in 1933 to the effect that "section 11 was designed not so much to compensate the investor as to create an *in terrorem* effect in the business community," and that this "aim is being achieved by the small number of cases." Comment, *BarChris, Due Diligence Refined*, 68 COLUM. L. REV. 1411, citing R. BAKER & W. CARY, CASES AND MATERIALS ON CORPORATIONS 1125 (3rd ed. unabr. 1959). That the civil liability section was perhaps designed to have an *in terrorem* effect on the business community is not in dispute, see *supra* note 6, at 173. It is doubtful that this has in fact occurred. The alternative proposition gives credit to the bar and the accounting profession, but cites the chief cause of section 11 inaction to the SEC's exacting examination of registration statements. Given the numerous actions initiated by the SEC in either injunctive, criminal, or stop order proceedings, and the fact that the SEC invariably issues a letter of comment on every registration statement filed, which in almost every instance causes changes to be made in the statement or prospectus, not to mention the fact that many registration statements are

sistently performed by the Securities Exchange Commission, the integrity and competency of those preparing the registration statements,[10] and that settlement may have been effectuated in many instances, although few settlements have been reported.[11] But certainly it is not too readily doubted that a great deal of the neglect, concomitant desertion to other civil remedies, and of course settlement, was due not only to the inherent limitations of section 11, such as a security for costs provision,[12] a short statute of limitations,[13] and the totally compensatory nature of the section,[14] disallowing punitive damages of any sort, but also to the unclear and uncertain language of the section.

It should be borne foremost in mind at the outset that for all its significance *BarChris* may not, in the end analysis, generate any more section 11 activity than before. On the affirmative side, if there is a general tightening up of investigation procedures, and adequate safeguards are taken to ensure truthful and adequate disclosure of information, then the lack of suits under section 11 will stand as evidence that the purposes and principles of the Act are being fulfilled. On the other hand, if it is shown that adequate measures are not being taken, that there are in fact false or misleading prospectuses in circulation, then the continued paucity of actions under section 11 will more than likely indicate the desirability of modifying section 11 in order to make it a more meaningful recovery section. If this not be done, then the potentially more accessible and more lucrative recovery routes, such as section 17 of the Act,[15] and section 10(b) of the Securities Exchange Act of 1934,[16] which have already been utilized to

withdrawn, several due to the suggestion of the SEC as an alternative to a stop order proceeding (Loss at 316), the latter position seems without doubt to be more in line with common sense. *See* 3 Loss, *supra* note 8, at 316, 1690.

It bears mention that the staff of the SEC, already engulfed in work, and unable to catch every false or misleading registration statement because of the sheer volume, has just initiated a new policy of giving only a cursory review rather than the customary review to a portion of the registration statements filed, thus enhancing the possibility that more false and misleading prospectuses will be circulated to the public.

10. 3 Loss, *supra* note 8, at 1690.
11. *Supra* note 8.
12. 15 U.S.C. § 77k(e) (1964).
13. Section 13, 15 U.S.C. § 77m (1964). The statute of limitations is one year after discovery of the misstatement or omission, or after such should have been discovered by the exercise of reasonable diligence, but no more than three years after the security was first bona fide offered to the public.
14. *Supra* note 12.
15. 15 U.S.C. § 77q (1964).
16. The action is brought through a rule under the section, SEC Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968). The Securities Exchange Act, 15 U.S.C. § 78j(b) (1964) will hereinafter be referred to as the Exchange Act.

South Carolina Law Review, Vol. 21, Iss. 5 [1969], Art. 2



some extent, may find themselves host to the traditionally section 11 actions.[17]

It is to the *BarChris* court's treatment of the due diligence defenses and related matters, the attendant impact of the decision on the investment community, and the questionable effectiveness of section 11, as either an *in terrorem* deterrent to fraud or negligence, or as an accessable civil remedial vehicle, that this paper is directed. To place *BarChris* in proper perspective and to best understand the implications of section 11 the case will be presented in length, along with an historial and developmental discussion of section 11. To best gauge the practical effect, as well as the legal significance of *BarChris* to the investment community, a survey was taken of various counsel in the securities field and an analysis of the results of the survey is included in a later portion of the paper.

## I. THE SECURITIES ACT OF 1933 AND SECTION 11

### A. *The Basic Philosophy of the Act*

The basic purpose of the Act was to bring about "truth in securities."[18] The Act was written so as to effectuate this basic policy with the requirement of full disclosure. As stated by Douglas and Bates: "All the Act pretends to do is to require the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth."[19] It is not the purpose of the Act to view the securities on their merits. Whether the securities are a "good" investment or "sound" is a determination left to the purchasing public.[20]

Congress ensured the public that not only would there be accuracy in the information disclosed through the registration statement and prospectus, but that there would be disclosure of significant matters that had rarely in the past been disclosed.[21]

17. *See* notes 200-201 and accompanying text. The writer does not attempt to argue the validity or propriety of utilizing other sections for traditionally section 11 actions, but only points out that they have been utilized.

18. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2, 3 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 251 (1933).

19. *Supra* note 6, at 171.

20. The purpose was amply noted by Professor Loss:

> Congress did not take away from the citizen his inalienable right to make a fool of himself. It simply attempted to prevent others from making a fool of him.

1 LOSS, SECURITIES REGULATION 128 (1961).

21. Shulman, *supra* note 18, at 227.

This is evidenced by the Act speaking to omissions as well as false and misleading statements.

To best understand the development and significant features of section 11 it would do well at this point to briefly view the English statute from which it was modeled, leaving the more complete analysis and comparison for later.

In 1933, when the Act was adopted, there was, as part of English law, the Companies Act of 1929.[22] This Act was developed from the Directors' Liability Act, 1890,[23] which, as indicated by Professor Loss, was a direct result of *Derry v. Peek*,[24] and the House of Lords' knowledge of the "impotence of the common law deceit action in the realm of securities."

Recalling the *Derry v. Peek* decision, and the court's reluctance to label the actions of "respected gentlemen" as "deceitful" and thus refusing to convict them, we bring into sharp focus the problems which faced the investor attempting to recover funds as a result of "negligent misrepresentation."

> The older action of deceit, true to its name, was a remedy for villainy .... Literally, the charge is a very serious one. It is, in effect, an accusation of thievery, of procuring money under false pretenses .... The remedy appropriate against deceitful rogues was not to be applied to respectable businessmen who believed their statements to be true, however unreasonably that belief was founded.[25]

The English Act overcame the *Derry v. Peek* implications and the basic common law requirements such as exhibited in *LeLievre & Deunes v. Gould*,[26] by negating the scienter requirement and placing upon the defendant the duty of showing reasonable grounds for belief in the truthfulness of the statement.

So too, and to effectuate the philosophy of full disclosure, the scienter requirement has been replaced by the due diligence defense of section 11(b). Also, the basic requirements of causation, reliance, and privity have been discarded, except to the extent that the defendants may show as a defense that the particular plaintiff knew of the misstatement or omission, at the time of acquisition, or that, in mitigation of damages, the plaintiff's

22. 19 & 20 Geo. 5, c. 23, § 37 (1929).
23. English Directors' Liability Act of 1890, 53 & 54 Vict., c. 64.
24. 14 App. Cas. 337 (1889).
25. Shulman, *supra* note 18, at 233.
26. [1893] 1 Q.B. 491.

loss was not totally occasioned by the misstatement or omission in the registration statement.[27]

It should be noted that the issuer—as distinguished from the signers of the registration statement, the directors, the partners, the accountants and the underwriters—is not afforded the due diligence defense, and thus, is in a sense an insurer against investor loss in the event there is a material misstatement or omission.[28] This is contrary to the English view which excludes the issuer from liability on the theory that the stockholders should not suffer for the wrongdoings of the individuals.

*B. Section 11—Some Initial Definitional Problems As To "Persons Liable" Under Sections 11 and 15*

Section 11(a) allows any person acquiring a security issued under the authority of an effective registration statement, which when such statement, or part thereof became effective,[29] contained an untrue statement of a material fact,[30] or omitted to state a material fact required to be stated therein, or necessary to make statements therein not misleading, to sue, either in law or equity, in any court of competent jurisdiction (1) every person who signed the registration statement;[31] (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the

27. 15 U.S.C. § 77k(e) (1964). However, if the purchase of the security occurred after the issuer had generally made available to its security holders an earning statement covering a period of at least twelve months after the effective date of the registration statement, the right to recover will be conditioned upon proof of reliance upon the untrue prospectus. This provision is based on the assumption that any purchase after the distribution of the statement will be predicated on the statement and not on the prospectus. 15 U.S.C. § 77k(a) (1964).

28. Section 11(b), 15 U.S.C. § 77k(b) (1964).

29. Section 8(a), 15 U.S.C. § 77h(a) (1964), specifies that a registration statement shall become effective 20 days after it is filed with the SEC, or 20 days from the date of any amendment filed, unless acceleration is requested or was set in accordance with SEC Rule 460, 17 C.F.R. § 230.460 (1969). Since the accuracy of the registration statement is judged from the effective date no liability will arise before that time. In accordance with this, no liability will arise from untruths or omissions contained in a preliminary prospectus, not part of the registration statement, and section 10(b), 15 U.S.C. § 77j(b) (1964), excludes summary prospectuses from section 11 liability. Lastly, it should be noted that no liability will arise under section 11, where events taking place subsequent to the effective date, which events tend to make inaccurate the registration statement, are not reflected in or by amendment.

30. *See infra* notes 103-07 and accompanying text.

31. *See* section 6(a), 15 U.S.C. § 77f(a) (1964), wherein it is stated that the issuer, the principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions must sign the registration statement.

registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him,[32] who has with his consent[33] been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report or valuation, which purports to have been prepared or certified by him; (5) every underwriter with respect to such security.

There is added to this list, through section 15 of the Act:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section [11] or [12] . . . .[34]

Although there was no "control" problem presented in *BarChris* it is certain that at some time the issue will be presented and in that regard interesting questions will arise as to what constitutes "control" for the purpose of section 15.[35]

The concept of control permeates the Act and has posed several difficult problems especially with regard to the last sentence in section 2(11),[36] which for the purpose of finding "a statutory underwriter" defines an issuer ". . . [as] any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." The issue usually poses itself in relation to a claimed section 4(1)[37] exemption for a sale of unregistered securities and although section 15 logically speaks only to "controlling" persons the task of defining control appears equally as difficult there.

---

32. There is some controversy with respect to an attorney as an expert for purposes of section 11 liability. *See* notes 67-69 *infra,* and accompanying text.
33. The consent must be in writing and filed with the registration statement. See section 7, 15 U.S.C. § 77g (1964).
34. 15 U.S.C. § 77o (1964).
35. For an interesting discussion of the control problems see Douglas & Bates, *supra* note 6, at 196.
36. 15 U.S.C. § 77b(11) (1964).
37. 15 U.S.C. § 77d(1) (1964).

This same control problem also arises under a section 4(4)[38] brokers' transaction exemption in relation to its rule counterpart, Rule 154,[39] which limits the amount of securities a broker may sell for a control person within a six month period, and Rule 133,[40] the "no sale" rule, which allows control persons to sell securities obtained through this transaction (a "cram down exchange") in equal amount to that allowed in Rule 154.

This most illusive concept is complicated by the wording of the various sections. The definition in section 15 includes not only those persons who exert control through stock ownership, but also those persons "who through *agency, or otherwise or through agreement or understanding* with one or more other persons by or through stock ownership, agency, or otherwise controls any person liable under section 11." This may include stockholder members of the household of a control person; it may include persons, who while not in a "stock control" position may by their wisdom or business acumen have a strong say in management of the company; it may include other corporations who by contract or by a strong minority stock position have guiding influence over the issuer or other persons liable under section 11, such as a director or officer.

## II. DEFENSES AFFORDED THE SECTIONS 11 AND 15 DEFENDANTS

### *A. The Section 11 Defendants*

There are defenses afforded to the section 11 defendants with the exception of the issuer who is held to some extent as an insurer. This is not to imply that the issuer is totally without relief. For instance, it may show that the plaintiff knew of the misstatement or omission at the time of purchase and thus escape liability.[41] Also, an amendment to section 11(a) has replaced reliance as an element necessary to be shown by the plaintiff where the issuer has made generally available to its security holders an earnings statement covering a period of at least twelve months beginning after the effective date of the registration statement.[42] Further, section 13, the statute of limitations applicable to section 11, which limits recovery (the filing of the lawsuit) to within one year after discovery of the misstatement or omission and

38. 15 U.S.C. § 77d(4) (1964).
39. SEC Securities Act Rule 154, 17 C.F.R. § 230.154 (1968).
40. SEC Securities Act Rule 133, 17 C.F.R. § 230.133 (1968).
41. 15 U.S.C. § 77k(a) (1964).
42. *See* note 27, *supra*.

in any event not more than three years after the security was bona fide offered to the public, bars recovery against the issuer as well as the other section 11 defendants.[43] Lastly, under section 11(e) the issuer as well as the other defendants can mitigate damages by showing that the depreciation in the value of the stock did not result from the improper registration statement.[44]

Liability can be avoided by any defendant, other than the issuer, provided that he can sustain the burden of proof—

> (1) that before the effective date of the part of registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceases or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or (2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of of the registration statement became effective without his knowledge; . . .[45]

Section 11(b)(3)[46] provides the key affirmative defenses for all defendants named in section 11(a) except the issuer. But beyond just creating a defense this section, read in conjunction with section 11(c),[47] dictates the duties and responsibilities of the defendants described in section 11(a) and sets the stage for the *BarChris* decision. These are the "due diligence" defenses.

Initially, it should be noted that section 11(b)(3) speaks in terms of "expertised" and "non-expertised" portions of the registration statement. The distinction is important for it delineates the various areas of responsibility and liability. The section provides an escape from liability for any defendant, other than the issuer, who sustains the burden of proof:

---

43. *See* note 13, *supra.*
44. 15 U.S.C. § 77k(e) (1964).
45. 15 U.S.C. § 77k(b) (1964).
46. 15 U.S.C. § 77k(b) (3) (1964).
47. 15 U.S.C. § 77k(c) (1964).

> (3) that (A) as regards any part of the registration statement *not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert,* . . . he had, *after reasonable investigation, reasonable ground to believe and did believe,* . . . that the statements therein were true and that there was no omission to state a material fact . . . and (C) as regards any part of the registration statement *purporting to be made on the authority of an expert (other than himself) or purporting to be a copy or extract from a report or valuation of an expert* (other than himself), he had *no reasonable ground to believe and did not believe,* . . . that the statements therein were untrue or that there was an omission to state a material fact . . . .[48]

As to the expert he must show that after reasonable investigation he had reasonable ground to believe and did believe that the statements contained in his report or valuation were true and that there was no omission to state a material fact.

Section 11(b)(3) is unclear as to the experts' liability for the unexpertised portions of the registration statement. Clarification comes from a reading of section 11(a)(4) which limits liability to those statements which purport to have been prepared or certified by the expert.[49] Stated simply, experts are responsible only for the portions of the registration statement they per-

---

48. *Supra* note 46 (emphasis added). The determination of who, or who is not, an expert is crucial, for it alters the defenses considerably. In short, the non-expert need not investigate into any of the expertised portions. The defendants will, of course, attempt to show that all or portions of the registration statement were prepared by experts. This was done in *BarChris,* where the defendants argued to the court that the entire registration statement was prepared by the attorneys and therefore "prepared by experts". The court rejected the argument. See notes 67-69 and accompanying text. Further, the SEC is especially aware that attempts will be made to "expertize" portions of the registration statement that do not demand expertization.

> This whole machinery obviously was intended for such parts of the registration statement as the financial data, appraisers' valuations, engineers' reports, the opinion of counsel as to the legality of the issue, and the like. The Commission will not permit the central data . . . to be 'expertized'. The loose use of 'hedge clauses' which seek to shift responsibility to experts is regarded a material deficiency. . . .

3 Loss, *supra* note 8 at 1741.

For the SEC ruling on the expertization of counsels' legal opinions see SEC Securities Act Rule 436(b), 17 C.F.R. § 230.436(b) (1969).

Thus, it is clear that the expertized portions must be limited to those portions that must be prepared by a specialist or professional.

49. *See* 3 Loss, *supra* note 8, at 1727.

sonally prepare. They incur no liability as regards the unexpertised portions.

*B. The Section 15 Defendants*

Section 15 states that these defendants "shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.*"[50]

Since there is no imposition of the task of reasonable investigation the section 15 defendant, in addition to having all the collateral section 11 defenses, is relieved of showing due diligence. Of course, there is the danger of "guilt by association", that is, since he is a controlling person, if that first be proven,[51] there may be a presumption that he has access to extensive information and thus had knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist. If this be the case then the defendant is going to have a difficult task in proving passive ignorance, even though section 15 only requires that of him.

There are situations where it is inequitable to allow the section 15 defendant the total benefits of the "passive ignorance" defense, namely in the area of secondary distributions made by the issuer on behalf of the controlling stockholder. Professor Loss illuminates the situation:

> Today, even when a registration statement is filed in connection with a secondary distribution by a person in in a control relationship with the issuer, that person is not liable under § 11 directly; he is liable only under § 15, since he need not sign the registration statement. If §6(a) were amended as proposed in 1941 . . . three changes would result in such a person's civil liability: (1) the plaintiff would not have to prove control as he does under § 15; (2) the defendant would not have the extra defense afforded by § 15; and, (3) the defendant

50. *See supra* note 34 (emphasis added).

51. The burden is on the plaintiff, when suing a section 15 defendant, to prove that the defendant was in a controlling situation. As previously indicated in notes 34 & 35, and the accompanying text, this may be a difficult task.

would be liable also if he were controlled by or under common control with the person initially liable, whereas § 15 applies only to persons who control.[52]

## III. ESCOTT v. BARCHRIS CONSTRUCTION CORPORATION: FOCUS ON SECTION 11, "MATERIALITY" AND THE IMPLICATIONS OF DUE DILIGENCE

### *A. The Factual Setting*

The primary business of the defendant issuer BarChris was that of building bowling centers. These centers included the basic building unit which housed the "alleys" or "lanes" and most often contained other facilities such as restaurants and lounges. The business, relatively small when initially formed as a partnership in 1946, grew substantially as a result of the development and introduction on the market of automatic pinsetting machines. This innovation was the stimulus toward making bowling a popular sport.

By 1960, BarChris, enjoying rapid growth as a consequence of bowling enthusiasm, had increased its sales dramatically[53] and was installing three per cent of all bowling lanes built in the United States.

The company's normal method of operation was to enter into a contract with the customer, secure a small down payment on the purchase price, then proceed to build and equip the center. When the building was completed BarChris would secure the balance in the form of an installment note which it then discounted with a factor, receiving part of the face amount in cash and leaving the remainder as a reserve at the instance of the factor.

Beginning in 1960 BarChris resorted to a second method of financing referred to in the case as the "alternative method"[54] which essentially was a sale and lease back arrangement of the interior of the building with the factor. Under this arrangement the factor either leased the interior directly to a BarChris customer or in several instances it leased the interior back to a subsidiary of BarChris formed just for this purpose. In turn, the subsidiary would then sublease to the customer. The major dis-

---

52. 3 Loss, *supra* note 8, at 1723.
53. According to the prospectus BarChris had net sales in 1956 of some $800,-000 and by 1960, it had net sales of $9,165,000. 283 F. Supp. at 653.
54. *Id.* at 654.

tinction between the two lease back variations was in the contingent liability features of each. BarChris retained a 25% liability to guarantee lease payments by the customers, but fully guaranteed performance of the lease agreement between the BarChris subsidiary and the factor.

Both methods of financing placed BarChris in a tight cash position and to this was added the compelling need to expend considerable sums of money to defray construction costs. This tight cash position became even more acute as operations expanded.

In 1959, in order to obtain working capital, BarChris sold 560,000 shares of common stock to the public at three dollars a share. By early 1961 it was in need of additional working capital and offered 3.5 million dollar principal amount of 5½% convertible subordinated debentures under a registration statement which became effective on May 16, 1961. As of this time BarChris' position was more precarious than ever. Customers were in arrears in payments to BarChris as well as to the factor. It was becoming increasingly apparent that the bowling industry was overbuilt and since many of the operations were initially undercapitalized they began to fail. Sales also fell off and by early 1962 BarChris was again in need of finances. It attempted another common stock offering, but subsequently withdrew its registration statement. On November 1, 1962, BarChris defaulted on the payment of interest due on the debentures.[55]

On October 25, 1962, purchasers of the debentures filed a class action[56] under section 11, alleging in the complaint numerous material and culpable errors in the prospectus regarding the balance sheet and income statements for the year 1960 and for the first quarter of 1961. They further challenged the accuracy of the prospectus and charged that it contained material misrepresentations and omissions. The prospectus contained, among other things, a description of BarChris' real property, material

55. On October 29, 1962, BarChris filed a petition for arrangement under Chapter XI of the Bankruptcy Act. The Chapter XI proceeding was converted into a straight bankruptcy in March of 1963. Thereafter the adjudication in bankruptcy was vacated and in November of 1963 BarChris was placed in reorganization under Chapter X of the Bankruptcy Act. The trustees in reorganization appeared in the instant case on behalf of BarChris. 283 F. Supp. at 654, n. 5.

56. The action instituted was a spurious class action as the same was designated under F.R.C.P. 23(a) (3) before it was amended on July 1, 1966. The court allowed the parties to continue under the old rule.

concerning its subsidiaries and comments on other aspects of its affairs. The financial information included a consolidated balance sheet as of December 31, 1961, with explanatory notes, unaudited figures as to net sales, gross profits and net earnings for the first quarter ended March 31, 1961, figures as to the company's backlog of unfilled orders as of March 31, 1961, as compared with March 30, 1960, and figures as to BarChris' contingent liability as of April 30, 1961, on customers' notes discounted and its contingent liability under the so-called alternative method of financing.

*B. Setting the Stage for Liability — The Issues and a Possible Clarification of "Materiality"*

"On the main issue of liability", the court stated,

> the questions to be decided are (1) did the registration statement contain false statements of fact, or did it omit to state facts which should have been stated in order to prevent it from being misleading; (2) if so, were the facts which were falsely stated or omitted "material" within the meaning of the Act; (3) if so, have the defendants established their affirmative defenses.[57]

*1. Misstatements and Errors in the Registration Statement.* The court found the registration statement to be inaccurate, containing false and misleading statements while excluding information necessary to make many statements contained therein not misleading.

Addressing the financial statements as of December 13, 1961, the court ascertained that sales were overstated by $653,900 due to a misapplication of the percentage of completion method of evaluating job completion ($148,900 — Worchester & Atlas Bedford contracts), an overstated contract price ($25,000 loan on Burke Lanes), and the inclusion in sales of the entire contract price of completed alleys which had not in fact been sold ($48,000 — Capital Lanes and Howard Lanes Annex). What appeared to be sales were actually intracompany transactions, *i.e.*, a sale and lease back arrangement between BarChris, the factor and a BarChris subsidiary.

Based on an improper sales figure the court found the figure for net operating income for 1960 to also be incorrect. The extent that it was incorrect depended upon the extent to which

57. 283 F. Supp. at 652.

the incorrect sales figures for the five alleys in question were carried into net profits. Profit, and consequently net operating income, were overstated, profit by $246,605.

With the net operating income figure incorrectly computed it followed that the computation for earnings per share was erroneous. The correct earnings per share figure should have been ten cents less than stated.[58]

Current assets were also overstated by the inclusion of $147,466 in cash, which figure actually represented a temporary return of the reserves to BarChris by the factor.[59] This money was to be returned within a month in order that the factor could have it as security. To treat it as cash on hand without explanation of its temporary nature was misleading.

Another misstatement in current assets was the inclusion of $125,000 as a receivable for the sale of Federal Lanes. Russo, the Vice-President, believed that $100,000 of the $125,000 was paid by Federal stock in lieu of cash. The court stated that if this were true then the stock should have been shown as an asset of BarChris. It was not. The stock in actuality constituted security and not a down payment.[60] The court held that in any event since Federal was in bad financial straits on December 31, 1961 (in arrears to the factor Talcott on a discounted BarChris note) a reserve should have been set up in the amount of $50,000, thus reducing current assets by that amount.

Continuing to examine the current asset figure the court found that the company was treating the entire amount of the reserves held by the factor as a current asset. Since part of the reserves, in the normal course of business, would not have been released within one year and since a portion of it would never be released due to customer defaults on the notes it was error to treat the entire amount as a current asset. In total, current assets were overstated by the sum of $609,689.

Contingent liabilities (on notes discounted and on lease agreements) was understated by $375,795. There was a failure to

58. The prospectus listed earnings at 75¢ per share, but the court's calculation found it to be 65¢ per share. *Id.* at 660.

59. The transaction was not a direct one. Talcott, the factor, delivered the reserves to BarChris Financial Corporation, a wholly owned subsidiary of BarChris Construction, and BarChris Financial then turned the money over to BarChris. The court did not mention whether this was in fact a "masking", although it would have appeared to be so. *Id.* at 661.

60. 283 F. Supp at 662.

compute at 100% the liability BarChris had incurred by fully guaranteeing the leasing agreements between the factor and the BarChris subsidiaries. This liability was computed at 25%, the amount BarChris usually guaranteed on direct leases to customers with the standard factoring agreement.

The court then addressed the 1961 figures, holding that the errors in sales and contingent liabilities in the 1960 figures were carried over into the unaudited figures for the first quarter of 1961. To these figures more error was injected.

The contingent liability figures as of April 30, 1961 were understated by $618,853 due to a failure to compute BarChris' liability at 100% for the lease obligations of its subsidiaries.

The net sales, gross profit and net earnings figures were erroneous. Due to two intracompany transactions (Bridge Lanes and Yonkers Lanes—both operated by subsidiaries) there was an improper inclusion in sales of $519,800 and a consequent improper gross profit overage of $230,755, thus reducing net earnings proportionately.

The backlog as of March 31, 1961 of customer orders was overstated to the amount of $4,490,000 by including contracts which had been cancelled (Woonsocket, which became an intracompany transaction, and Atlas-Lincoln) or which should not have been considered as "firm" (Six T-Bowl interiors and Bowl-a-Way), reducing the figure from $6,905,000 to $2,415,000 on unfilled orders.

The court found that the text of the prospectus contained false and misleading statements with respect to officer loans, use of proceeds, customer delinquencies and in the description of BarChris' business.

The prospectus expressly stated that all advances had been repaid and this was meant to include loans made to BarChris by three officers to the amount of $155,615. The court found that while BarChris had issued checks to these three officers on March 13, 1961, it was in fact waiting for the proceeds of the debenture issue to cover the checks and by agreement the checks (save one) were not to be tendered until after the proceeds had been received and deposited. In any event new advances were made to BarChris shortly before the effective date for which BarChris immediately issued checks but again with the understanding that the same would not be cashed until after the proceeds of the debenture issue had been received.

It was further found by the court that the portion of the prospectus describing the intended use of the proceeds for the "construction of a new plant", development of a "new equipment line", for a loan to a subsidiary with the remainder to be kept for working capital, was thoroughly false in that 60% of the proceeds was intended to repay officer advances, bank loans, prior construction costs and for a loan to friends of one of the officers.[61]

The statement in the prospectus that "[s]ince 1955, the Company has been required to repurchase less than ½ of 1% of such promissory notes discounted by such unaffiliated financial institutions"[62] was impliedly false and misleading in that it gave the impression that BarChris was experiencing no customer difficulties when in fact by April 21, 1961 BarChris knew that it would have to repurchase delinquent notes on at least four centers totaling in excess of $1,350,000.

Lastly, the court also found misleading the failure to describe BarChris' business as including, besides the construction of the centers and their interiors, the engaging in the actual operation of one alley and the intention to operate two more as well as the possibility that it may have to operate several more because of pending customer delinquencies and defaults. It was stressed that the risks and problems in operating a center were obviously different from those involved in constructing one.

*2. Materiality.* In order for a plaintiff to recover for the false or misleading statements in the prospectus he must show that the facts misrepresented were "material" in nature.

The court initially adopted the definition of material from the SEC regulations:

> The term "material", when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the securities registered.[63]

In setting forth a more specific interpretation of the materiality test the court stated:

61. *Id.* at 676.
62. *Id.*
63. SEC Rule 405(1), 17 C.F.R. § 230.405(1) (1969).

> The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature and condition of the issuing corporation or its business.[64]

Applying the test to the 1960 financials the court held most of the errors in the figures not material and especially found that the overstated sales and understated contingent liabilities were not bad enough to deter the average prudent investor from purchasing the securities even if he had known the true facts.

Since the debentures were characterized as speculative[65] the primary attraction to the investors was the convertability feature coupled with the growth potential of the company, and what Judge McLean did find materially misleading in the 1960 figures was that when taken together the overstated current assets and the understated current liabilities resulted in a divergence in the net current asset ratio from 1.9 to 1 to 1.6 to 1. The court held that 1.9 to 1 was bad enough, but 1.6 to 1 would have made a significant difference, even to a growth oriented investor.[66]

Regarding the misstatements and omissions relating to the state of affairs of the company in 1961 the court experienced no difficulty in finding them all to be material.

*3. The Due Diligence Defenses.* Having determined that the prospectus had in fact contained materially false and misleading statements and omissions the court faced the unique and heretofore undefined due diligence defenses.

Initially there was a claim that the attorneys for the issuer and the underwriter were "experts" within the meaning of the section and thus responsible for the entire registration statement since they had prepared it.[67] The court rejected the contention

---

64. 283 F. Supp. at 681. The court quoted from *Charles A. Howard,* 1 S.E.C. 6, 8 (1934), where a material fact was defined as:

> . . . a fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question.

*Cf.* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965) . . . Restatement of Torts § 538 (2) (a) (1938); Restatement (Second) of Torts § 402B comment g (1965).

65. The securities were given a "B" rating by the investment rating services. 283 F. Supp. at 681.

66. *Id.* at 682.

67. *Id.* at 683.

out of hand stating that to do otherwise would be an unreasonable interpretation of the statute in that it would hold an attorney as an expert simply because he worked on the registration statement.[68] The court was obviously aware that to hold otherwise would expertise the entire registration statement thus reducing the defendants' duty to investigate to one of merely proving that they had no reason to believe that the registration statement contained untruths.

The accountants were the only ones held to be experts and thus as to the portions which purportedly were prepared by them as experts they had to show that an investigation was made to ascertain the truth of the statements contained therein while the other defendants had to show that they had not reason to believe that they contained anything other than the truth.

It is assumed that attorneys could be experts within the statutory definition if in a particular instance they held themselves out as experts, as for instance if they were to give an opinion as to pending legal proceedings or as to the legality of the securities being offered. But like every other expert there is a requirement that they file their consent to be named as an expert.[69]

*The "Inside" Officers and Directors.* The President, Vice-President, Chief Executive officer and most of the directors of the company were held to have been aware of the company's affairs, had failed to make an investigation and thus had not sustained the burden of proving due diligence.

The Treasurer and Chief Financial officer were found to have purposely withheld information from the accountants and as such could not maintain their due diligence defense.

The Comptroller was held to have been aware of specific misstatements in the financials defeating his due diligence defense as to the expertised portions of the registration statement. Further, he was found to have made no investigation as to the truth of the unexpertised portions and as such could not sustain his defense in this regard either.

The last insider, the company Secretary, who was also an attorney, was allowed to rely on the audited figures since he did

68. *Id.*
69. *See supra* note 48.

not participate in the management of the company and thus had no personal knowledge of the company's books of account or financial transactions. But he was not without some knowledge of the company's affairs as the court found, for it was established that he was aware of the existence of all of the subsidiaries since he had formed them himself and had an insight into several of the affairs of the corporation having prepared the company minutes. The court skirted the question of whether he had sustained his burden as to the expertised portions but held instead that since he had not conducted an investigation he had not sustained his burden as to the unexpertised portions. "As a lawyer he should have known his obligation under the statute."[70]

*The Outside Directors.* Liability was imposed on three outside directors after they failed to establish their due diligence defense as to the unexpertised parts of the registration statement even though all three had become directors on the "eve of the financing" and consequently had little opportunity to familiarize themselves with the company's affairs:

> Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new. This is not a sensible construction of Section 11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors.[71]

All of these men were very reputable, one enjoying a position as chairman of the board of a bank, one being a civil engineer,

70. 283 F. Supp. at 687.
71. *Id.* at 688.

and the last being a partner in the primary underwriting firm handling the debenture issue. Other than a preliminary check through Dun & Bradstreet and a check of the BarChris banks by the board chairman no further investigation was made either by him or by the engineer.

Coleman, the underwriter partner, made preliminary investigations to ascertain whether his firm should undertake the financing of the debenture issue. He continued to investigate until he was elected as a director at which time he ceased to investigate relying solely on the underwriters' counsel to complete the investigation. As will be shown Ballard, underwriters' counsel, failed to make a proper investigation and as a result Coleman was bound by his failure.

The court did find that all had a sound basis for relying on Peat, Marwick and Co., the accountants. None had any reason to believe that the figures were untrue, and thus all had sustained their defense as to the expertised portions.

The court treated the issuer's counsel in special fashion. This director was also a partner in the law firm which had prepared, besides the debenture registration statement, the registration statement for the common stock issued in 1959 and for the warrants issued in January of 1961.

Although he was sued in his capacity as a director and not as a lawyer, in his unique position, as the court stated, "more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work."[72] The defendant contended that to hold that he had not made a reasonable investigation was in essence to have required him to have made an independent audit of the figures supplied to him by his client and was also tantamount to holding that he could not rely on his client's statements.

The court believed that he had no knowledge of the errors in the 1960 figures, stated that he was not obligated to investigate them, and held that he had sustained his due diligence defense as to the expertised parts of the registration statement.

Concerning the unexpertised portion he could not rely on the statements of his client and thus had failed to establish his defense in that regard since he had failed to read the factoring agreements where he would have discovered BarChris' contingent liability on the subsidiary leasing agreements was 100%

72. *Id.* at 690.

instead of 25% and that upon default, and in the event that BarChris did not repurchase the notes on demand the factor could accelerate payment on all customer paper in its hands; had failed to request and read all contracts pertaining to unfilled orders, which on the company's books meant firm commitments; had failed to read the minutes of the various subsidiaries which would have revealed that BarChris was about to operate two bowling centers; had failed to have the minutes of certain Executive Committee meetings typed up which, if done, would have revealed that the company was constructing or about to construct twelve centers for which it had no contracts and would have further discovered that one of the most flagrantly delinquent customers had filed a bankruptcy petition in Chapter X; had failed to adequately inquire into officers' loans and vice versa; had failed to verify statements as to the intended use of the proceeds from the debenture sale; and had failed to examine the records as to delinquencies, records which BarChris management had kept. Lastly, as the court points out, had he inquired of the factor Talcott or examined the correspondence between BarChris and Talcott he would have discovered the true facts and consequently would have been aware of the falsity of the statement regarding delinquent customer note repurchases.

> After making all due allowances for the fact that BarChris's officers misled him, there are too many instances in which Grant failed to make an inquiry which he could easily have made which, if pursued, would have put him on his guard. In my opinion, this finding on the evidence in this case does not establish an unreasonably high standard in other cases for company counsel who are also directors. Each case must rest on its own facts.[73]

*The Underwriters.* None of the underwriters, except the managing underwriter, made an investigation and the limited investigation made by one of the partners of the managing underwriter along with underwriter's counsel was held to be unreasonable. Rather than reading the major contracts, inquiring into the factoring agreements, or reviewing the minutes of the parent and subsidiary corporations, underwriter's counsel was content to rely upon the representations of management to verify the information contained in the registration statement. Of course,

73. *Id.* at 692.

some investigation was made, some minutes were read, and some meetings were attended where the registration statement was reviewed and revised, but on the whole counsel was content to accept answers to questions rather than in attempting independent verification.

> In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them.[74]

The court found almost no attempt to verify management's representations.

The managing underwriter delegated its investigative responsibility to its counsel and it is therefore bound by the unreasonable performance of that task. Since the investigation is concerned mainly with facts the underwriter cannot claim reliance upon legal advice to establish its due diligence defense. The other underwriters likewise could not rely on the managing underwriter and its counsel and they are all bound by the failure reasonably to investigate. The court did not decide whether the group underwriters would have been liable for failing to investigate in the event that the managing underwriter was found to have established its due diligence defense.[75]

*The Accountants.* Judge McLean had previously ruled that the accountant's liability was limited to only those portions of the registration statement purporting to be made on its authority as an expert, namely the 1960 financial figures. But, he counseled, the belief in the accuracy of those figures must be measured as of May, 1961, the effective date of the registration. As a consequence the court placed great emphasis on the accountants' "S-1 Review".

The purpose of an S-1 Review (a review of events subsequent to the date of the certified balance sheet) is to ascertain whether any material change had occurred in the company's financial situation which should be disclosed in order to prevent the certified figures from being misleading.

The court, for the most part, ignored the 1960 audit, never came to an express determination that the investigation for the

74. *Id.* at 697.
75. *See* notes 152-57 *infra.*

preparation of the certified financial was unreasonable, rather only implying the same. It chose to expressly condemn the defendants' haphazard S-1 Review, labeling the results as "useless", while holding that the written program for review, although not followed, was in accordance with generally acceptable auditing standards.[76]

In his review the accountant merely read the directors' minutes given to him by a company officer, which minutes did not include minutes of the executive committee, or from any of the subsidiaries, and compared the quarterly trial balance figure with the 1960 figure.

## IV. ANALYSIS — PLACING BARCHRIS IN PERSPECTIVE

### *A. Development and a Comparative Analysis with an English Forefather*

As earlier noted, section 11 was modeled substantially from English law, and section 11 fairly well follows section 37 of the Companies Act, 1929, in spirit if not in language.[77] But there are significant differences which could or should affect the liability issue.

First, unlike section 11, the English statute does not hold the issuer liable, but rather excludes it as a defendant.

Second, section 11(b)(3)(A) speaks directly to a duty on the part of the defendant, as to the unexpertised portions of the registration statement, to reasonably investigate. Thus, unlike its English counterpart, section 37(1)(d)(iv), section 11 requires affirmative investigation in order to establish innocence. This may very well charge the section 11 defendants with a higher standard than the defendants in an equivalent Companies Act situation.

Third, although section 11 constantly refers to "untrue statements" as a basis for liability, as does section 37 of the Companies Act, it specifically includes reference to liability arising also from the "omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ." Neither section 37, Companies Act, 1929, nor section 43, Companies Act, 1948,[78] make reference to omission in

76. 283 F. Supp. at 701.
77. *Supra* notes 22 & 23.
78. 11 & 12 Geo. VI.

either of the contextual settings aforementioned. This too, on its face, seems to expand the section 11 defendant's liability.

But uniquely enough the English seem to have a more stringent requirement as regards the non-expert's liability for the statements and reports made by an expert. In the 1929 Act, section 37(1)(d)(iv)(b)&(c),[79] the defendant could be held for the incompetence of the expert. At that time the burden was on the plaintiff affirmatively to show that the defendant had no reasonable ground to believe that the expert was competent to make a report. The Companies Act, 1948, reversed the point in regard to burden of proof at section 43(2)(d)(ii)[80] and Chitty's Annual Statutes[81] makes the comment:

> As regards the liability of other persons for untrue statements in an expert's report the onus is now shifted to them to establish that they believed the expert competent to make the report.[82]

Section 11 makes no affirmative requirement that the non-expert determine the competency of the expert. They are charged only with the burden of proving that they had no reasonable ground to, and did not, believe that anything in the expertised portion of the registration statement was untrue.[83]

This distinction between Acts has great significance for several reasons. The defendants in a section 11 action are not charged by the Act to ascertain the competency of any expert, including the accountant. Since accountants, for the purpose of the registration statement, must be independent, the issuer's management, if attempting to hide something, may not be disposed to employ one of high calibre.

Further, the question of competency is a question of degree. Certainly a factor in establishing this degree would be the amount of experience the particular accountant has. This could have been a critical factor in *BarChris* where one of the auditors doing most of the auditing work and investigation was neither a Certified Public Accountant, nor seasoned with experience.

The Companies Act addresses itself, through section 43(3)(c) to the experts' liability, indicating that the possibility of liabil-

79. *Supra* note 22.
80. *Supra* note 78.
81. 42 Chitty's Annual Statutes, 11 & 12 Geo. VI, § 43 (1948).
82. *Id.*
83. Section 11(b)(3)(C) (1964), 15 U.S.C. § 77k(b)(3)(C) (1964).

ity on the part of the expert is enhanced if *he* cannot show, *in his defense*, that *he was competent to make his report.*[84] Again, with reference to *BarChris*, and if section 11 had a comparable provision, the accountants would have had to prove not only the competence of the firm, but the competence of the particular individual doing the work. This would be perhaps as it should be.

The reasonable investigation language of section 11(b)(3) is qualified by section 11(c) which reads as follows:

> [I]n determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.[85]

There is a footnote to this section indicating that it had been amended from its initial reading which had set the standard of reasonableness as that of a prudent man occupying a fiduciary relationship.[86]

That the change in the definition may not significantly affect the duties imposed upon those listed in section 11(a)[87] imports the query as to whether section 11(c) in its present language is not surplus verbiage in the first place. There is no counterpart of section 11(c) in either the 1929 or 1948 Companies Acts. We must keep in mind also that there is no express duty to investigate in either Act, yet as we shall see from *Adams v. Thrift*,[88] an English case, these elements may be automatic implications.

The purpose of the 1934 change was to "avoid the possibility of an over-zealous judicial construction of the term 'fiduciary relationship' ", though in truth the amendment was probably unnecessary. Indeed, Professor Loss states:

> Largely for psychological reasons, so it seems, Congress also changed the 'standard of reasonableness,' with respect to investigation and ground for belief, from 'that required of a person occupying a fiduciary relationship'

84. For the 1929 provision *see* Companies Act, 1929, note 22 *supra,* at section 37(1)(iv)(c).
85. 15 U.S.C. § 77k(c) (1964).
86. Amended by Public Act No. 291, 73d Cong. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934).
87. See 3 Loss, SECURITIES REGULATION 1726 (1961).
88. [1915] 2 Ch. 21 (C.A.). *See* notes 113-14 *infra,* and accompanying text.

> to 'that required of a prudent man in the management of his own property.' This is substantially the standard adopted in the *Restatement of Trusts* and applied under the English Companies Act; the English courts recognize that a director may rely on clerks and other competent persons for information concerning the business, but do not regard reliance on the statements of promoters or approval of the prospectus by other directors as a defense. Indeed, even under the original 'fiduciary' standard, the conference report on the bill which became the Securities Act recognized that a fiduciary need not 'individually perform every duty imposed upon him,' but may delegate to others 'the performance of acts which it is unreasonable to require that the fiduciary shall personally perform,' especially 'where the character of the acts involves professional skill or facilities not possessed by the fiduciary himself.'[89]

In light of *BarChris* one wonders just how much delegating can be done and to what extent the directors may rely on clerks or professionals in garnering information during an investigation. For instance, may a director rely on the company's accountant or the independant accountant's uncertified figures such as were contained in the 1961 BarChris financials?

> As to the non-expertised portions, however, Auslander is in a different position. He seems to have been under the impression that Peat, Marwick was not correct . . . Auslander made no investigation for the accuracy of the prospectus.[90]

But even when reliance is not placed on an expert[91] or a professional there certainly will be instances when the director ought not to rely on other company personnel. The dangers are obvious: Employees may stand in a favored position with the

89. *See* Loss, *supra* note 87. *See also,* Douglas & Bates, *Some Effects of the Securities Act upon Investment Banking,* 1 U. CHI. L. REV. 283 (1933).

90. 283 F. Supp. at 688. *But, cf.,* Litwin v. Allen, 25 N.Y.S.2d 677 (Sup. Ct. 1940); Stevens v. Hoare, 20 T.L.R. 407 (Ch. 1904). *See* notes 93-95 *infra.*

91. A corollary question arises as to whether the outside director may delegate the duties of investigation to an outside investigation service and thus satisfy his due diligence defense. *See* Note, *Securities Act of 1933-Misleading Prospectus-Directors' Liability Under Section 11-Due Diligence Defense,* 42 TEMPLE L.Q. 81, 86 (1968). The question more properly relates to the issues of "hedging" (*see* note 48, *supra,* and accompanying text) and indemnification (*see* notes 185-93 *infra,* and accompanying text). Suffice it to say for the moment, that employing such services would be a positive factor in favor of the director, but total reliance on the findings of such service would seem to be unreasonable.

insiders and consequently will protect or be influenced by them; employees will often tell the directors only what they think the directors want to hear; employees, as well as management, are not willing to disclose unfavorable information which may reflect upon them, their fellows, or the officers.

Much more fascinating is the application of section(c) and the question of delegation as concerns underwriters.

Judge McLean stated that "The underwriters are just as responsible as the company if the prospectus is false."[92] While the judge was not really holding the underwriters as "insurers" as section 11 nearly treats the issuer, he did not define what a reasonable underwriter's investigation would be, nor did he explore section 11(c) further than holding that a prudent man would have made a more extensive investigation than did underwriter's counsel and since the underwriters delegated the task to counsel they were bound by his failure.

The underwriters did not argue reliance upon their counsel, but rather argued *Litwin v. Allen*,[93] a case which held that a director of a corporation may rely upon information furnished him by the officers of the corporation without independently verifying it, and they stated that this was analogous to the underwriters' position with the company. It was their contention that the case established a standard of reasonableness for the reasonably prudent director and that the same should be the standard for the reasonably prudent underwriter under the Act. The argument was rejected on two grounds:

1. New York law does not govern the case. "The construction of the Securities Act is a matter of federal law."[94]

2. The two situations are not analogous. "An underwriter has not put the company's officers 'into a position of trust for the express purpose of attending to details of management.' The underwriters did not select them. In a sense, the positions of the underwriter and the company's officers are adverse."[95] It is not unlikely that statements made by the company officers to an underwriter to induce him to underwrite may be self-serving.

Some guidelines as to the delegation of duties is found within the basic law of trusts. A trustee has a standard duty to dis-

92. 283 F. Supp. at 696.
93. 25 N.Y.S.2d 667 (Sup. Ct. 1940).
94. 283 F. Supp. at 696.
95. *Id.*

charge his trust obligations in good faith, with the competence of a prudent man in the management of his own property,[96] and when the trustee possesses special or exceptional skills or has access to more extensive facilities, he will be held to a higher standard at least to the extent that he holds himself out as being possessed of these special qualities.[97] As already noted,[98] there may be a delegation of duties to another under the fiduciary standard where it would be unreasonable for the investigator to perform the acts personally, especially when the delegation is to one possessed of greater skills than the delegator.[99]

If the underwriters are truly adverse to the issuer then there can be no delegation to, and concommitant reliance upon, any of the officers or directors of the issuer. Further, since the matters to be investigated are factual in nature there ought not to be any delegation of duties to an attorney, since not only is the underwriter possessed of the same skills as the attorney, but such delegation would seem unreasonable under all the circumstances.[100]

Unlike the attorney, the underwriter's stock in trade is financial analysis. Besides employing skilled men in this area the underwriter has extensive facilities at its disposal, all of which are centered around market and financial analysis.

What seems clear is that the underwriter plays an important integral role in the investigatory schemework of section 11. While it is doubtful that he could delegate any of this responsibility it is truly unclear as to just how extensive a role he should play.[101]

> It seemed impossible to define in statutory language the extent to which a fiduciary might lawfully delegate

---

96. *See* RESTATEMENT (SECOND) OF TRUSTS § 170 (1959) (loyalty); *id.* § 174 (competence); *cf.* H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933) ("a duty of competence as well as innocence"). Note, *Escott v. BarChris: "Reasonable Investigation" and Prospectus Liability under Section 11 of the Securities Act of 1933,* 82 HARV. L. REV. 908, 911 (1969).

97. *See* RESTATEMENT (SECOND) OF TRUSTS § 174. Note, *Escott v. BarChris, id.*

98. *Supra* notes 89-91, and accompanying text.

99. The investigator may discharge his responsibility if his reliance on the delegate's performance is "reasonable in light of all of the circumstances". H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933).

100. *Id.*

101. That they must investigate is clear. To the degree that they must investigate is unclear and is not aided by "federal law" except that decisions of the SEC have indicated that underwriters must go beyond and behind the repsesentations of the issuer. Matter of Richmond Corporation, 41 S.E.C. 398 (1963); Matter of Charles E. Bailey & Co., 35 S.E.C. 33 (1953).

> his duties to others. In lieu of such an effort, resort was made to general language in the report to indicate that a goodly measure of delegation was justifiable, particularly insofar as corporate directors are concerned.[102]

This section 11(c) "general language" proved fatal to the underwriters in *BarChris*, and will continue to be fatal to all underwriters absent some specific directions. This situation makes propitious further legislative clarification.

*B. Materiality*

The task of determining materiality has always been a difficult one and as Judge McLean indicated it was a difficult task in *BarChris*. The concluding remarks of the judge indicate the dangers:

> Since no one knows what moves or does not move the mythical 'average prudent investor,' it comes down to a question of judgment, to be exercised by the trier of the fact as best he can in the light of all the circumstances.[103]

Indeed, once misstatements or omissions are shown to exist in the prospectus, as for instance in the sales and contingent liability figures in the BarChris 1960 financials, could not the trier of fact easily find them to be material, especially when to do otherwise would result in the denial of recovery by innocent investors of lost funds? It would be the unusual case where the plaintiff would not testify to the fact that he relied on the particular false statements. Further, since the issue of materiality is subject matter for the triers of fact, one cannot help doubt that other factors, such as the degree of culpability, will substantially influence the ultimate determination.

Be that as it may, a case against a finding of materiality can be made. Professor Loss, in analyzing the various Rule 10b-5[104] cases in which judgment for the plaintiff was rendered on the merits, came to the conclusion that "material" probably means "damn material" and that the courts, in essence, were applying the "special circumstances doctrine".[105]

102. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 48 (1959). See Loss, *supra* note 87.
103. 283 F. Supp. at 682.
104. *Supra* note 16.
105. Proceedings, American Bar Association National Institute, *The BarChris Case: Prospectus Liability*, 24 BUS. LAW. 523, 533 (1969) [hereinafter cited as *BarChris Conference*].

Other authorities have not felt as strongly as Professor Loss as to the substantiality of the materiality test:

> [M]ateriality, like beauty, is in the eye of the beholder. Note for example Judge McLean's suggestion that while balance sheet discrepancies as of December 31, 1960, if known to the prospective purchaser would have deterred his purchase, discrepancies as to sales and earnings were not sufficient to have had the same effect. I have heard many a disagreement and there can be no satisfactory and complete reconciliation. All I can suggest is that counsel must approach the question of materiality as if he were defending a corporate fiduciary who under *Geddes v. Anaconda Copper Company* [254 U.S. 590 (1921)] has the burden of proving the fairness of his transaction with his corporation. Everything is 'material' until the contrary is proven if not beyond a reasonable doubt at least by a preponderance of the evidence; or it is clearly established that its financial significance is minuscule.[106]

One expert set forth specific criticisms of the court's determination of materiality:

> The application of the materiality concept by the Court to the facts of the *BarChris* case is at least somewhat surprising. The Court concluded that the 14 percent error in earnings for 1960 was not material . . . . I daresay that any accountant who discovered that he had made an error of 14% in the income statement of a client would be horrified and very few would be inclined to dismiss such a discrepancy as 'immaterial' . . . .
>
> [A] 14% discrepancy which reduces earnings from 75¢ a share to 65¢ a share results in a $3.20 difference in market price, to many people a not inconsequential differential. In this particular it would appear that the

106. Statement of Carlos Isreals, *id.* at 539.

There was one other view concerning materiality as it was applied in *BarChris* that merits attention. It was one expert's contention that Judge McLean had differentiated between materiality as to recent facts and materiality as to more vintage facts. He pointed out that the Judge had indicated that the errors in the 1960 financials were bad, but in essence ignored them to concentrate on the 1961 unaudited financials, showing perhaps that the more historical facts were less important and the more recent, as a consequence were "more material". Statement of F. Arnold Daum, *id.* at 554-55.

> Court was conservative and that its conclusion might be challanged. . . .
>
> It is submitted that the Court's conclusion that the auditors were liable because of the error in the current ratio, even if it is concluded the auditors were negligent in the particulars the Court says they were, is incorrect. The Court first remarked that the ratio . . . was 'bad enough'. Was it so bad? Two-to-one is regarded as something of a standard. In the construction industry the median in 1959 was 1.81. Thus there is some question whether the ratio in the balance sheet or even as adjusted was as lamentable as the Court said.[107]

In the end analysis, as a practical matter, the problem of materiality will probably be settled depending upon the particular merits of the case. Ordinarily any misstatement or omission will be held "material" enough to overcome a defendant's motion for summary judgment and this alone is usually sufficient to prompt settlement.

### *C. Investigation and Verification—The Case in Historical Perspective*

*1. The Directors' Duty to Investigate.* Section 11 makes no distinction between inside and outside directors as to liability or as to the degree of investigation necessary to sustain the burden of proving due diligence. As previously discussed[108] the general standard as to what constitutes reasonable investigation and reasonable belief set forth in section 11(c), is that which is required of a prudent man in the management of his own property. Before *BarChris* the standard was not stringently applied,[109]

107. Statement of A.A. Sommer, Jr., *id.* at 593, 598-599.

108. *See* notes 85-91 *supra,* and accompanying text.

109. *See* Martin v. Hull, 92 F.2d 208, 209-10 (D.C. Cir. 1937), *cert. denied,* 302 U.S. 726 (1937), where the plaintiffs unsuccessfully attempted to have the court charge the jury that as a matter of law "if the defendants did not exercise 'the high degree of care necessary in the protection of the interests of the stockholders of the Corporation, then they have not acted as reasonably prudent men would have acted'." Section 11(c) was read to the jury. Two comments can be made as to the decision: one, the decision does not indicate, since the jury did not, whether the defendants had sustained their section 11(b)(C) defense on the section 11(c) interpretation, or whether the jury had held for them on the defense that the plaintiffs knew of the misstatement at the time of acquisition (the appellate court indicated that evidence was tendered to show such knowledge); and two, the only section 11(b) defense was that based on misstatements in the "expertized" portion of the registration statement and thus section 11(c) as it related to section 11(b) reasonable investigation, was not considered.

but it was always assumed that the director would no longer have merely a perfunctory role to perform:

> The Act imposes a minimum duty on all directors which would 'have a direct tendency to preclude persons from acting as nominal directors' and 'result in persons retiring from many boards and confining their efforts to a few boards where they will actually direct.'[110]

As with the underwriters, the directors, although under a mandate to reasonably investigate, are left without guidelines indicating the necessary extent of the investigation required of them.

It is interesting to note that the directors, unlike the underwriters, did not argue the applicability of the case of *Litwin v. Allen*,[111] although the principles announced in the case were more applicable to the directors than to the underwriters. *Litwin*, as recalled, stood for the proposition that a director may rely upon information furnished him by the officers of the corporation without independently verifying it.[112] Since *Litwin* was not argued in proper context, *i.e.*, in relation to the directors, it was not expressly rejected by the court as having no substantive force in formulating section 11 doctrine, although the court leaves little doubt that if the issue had been raised by the directors it would have been rejected in favor of the *Adams v. Thrift*[113] principle. Following the mandate of *Adams*, Judge McLean held that directors could not rely on the representations of management.[114]

---

110. S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933). See *BarChris, Due Diligence Refined, supra* note 9, and Douglas & Bates, *Some Effects of the Securities Act Upon Investment Banking,* U. CHI. L. REV. 283, 291, n. 29 (1933).

111. *Supra* note 90. See also accompanying text.

112. *See* N.Y. BUS. CORP. LAW § 717 (McKinney 1963) which codifies this principle.

113. *Supra* note 88.

114. Judge McLean placed heavy emphasis on *Adams,* to the exclusion of domestic decisions, in holding the outside directors liable for failing to investigate to a degree required of a prudent man in the management of his own affairs, even though as already mentioned neither the Directors' Liability Act, 1890, nor the Companies Act, 1929, has a prudent man provision. In *Adams,* a suit by a stockholder against the directors for false misstatements in the prospectus, the court seemed to imply that the defendant-directors could have sustained their defense if they had collectively investigated, and failing that, if they had individually investigated:

> Had the board here *collectively made or set about making an investigation* such as I have indicated, and had that investigation led to a report that the statements were found on fact and were substantially true, *there is little doubt but that each member of the board might and would have been held to have had reasonable ground for entertaining the belief that the statements were true.*

Even assuming for the moment that *Litwin* still has vitality, the rationale for its holding can be clearly distinguished from that underlying the *BarChris* decision, by analyzing the roles the directors played in the various transactions involved in the two decisions.

> Where the directors, as in *Litwin*, are merely approving a corporate transaction . . . their interests are completely identified with those of the corporate management in that the only interests at stake are those of the corporation itself. The complexity of the transaction may make it virtually impossible for the directors to analyze independently the thinking which goes into such transactions. . . .
>
> When the director is considering only a transaction which effects [*sic*] the management and operations of the corporation itself, he may reasonably rely on representations of management, except to the extent that his own personal familiarity with the operations of the company arouses in him suspicions which he ought to eliminate by independent verification. On the other hand, where the outside director is charged with the duty of lending his name and reputation to representations about the *existing* status of the company, on which the investing public will necessarily rely, he *must* place himself in the shoes of the shareholders and of the in-

---

*Id.* at 565 (emphasis added).

While investigation is not expressly required under the English law, nonetheless to establish reasonable belief in the statements, there must be corroboration of the facts which consequently requires investigation.

The statement on "collective investigation" has broader implications than the case allowed, for the court throughout had held that none of the defendants had any foundation for believing that any of the others knew more than they, which was relatively little:

> Dr. Clarke's evidence shows that he unfortunately did not appreciate the duties and obligations he was undertaking as a director, and personally he had seen nothing in the conduct of his co-directors calculated to lead him to conclude that they appreciated more than he did the duties and obligations of his office. As I have said, collectively they had done nothing; . . .

*Id.* at 568.

Had some of the directors, besides showing an expertise in the company, undertaken an investigation, would the others be able to rely on their findings and representations? The court in *Adams* speaks to this possibility. Whether the court intentionally considered the thought, the concept of "collective investigation" might be a feasible potential alternative to the burden of individual investigation as dictated by *BarChris*. Of course, some refinements would be in order to stay within the policy of *BarChris*, such as segregating the outside directors from the inside directors and holding each group to separate standards.

> vesting public (the potential shareholders of the company) and satisfy himself independently that each representation has a firm factual basis. Thus, the role of the director in federal securities law is distinctly different from his role in the case of an ordinary corporate transaction which he is called upon to approve.[115]

The above analysis is also consistent with the English position which allows directors to rely on knowledgeable employees and clerks for information concerning the company,[116] but does not extend the defense to the director when he relies on others for information placed in the prospectus.[117]

Regarding the crucial question of the degree of investigation, as opposed to the issue of delegation, the House and Senate early disagreed.[118] It was the Senate's desire to hold the issuer, directors, chief executive and financial officers somewhat as insurers. On the other hand the House bill measured liability in terms of reasonable care, placing upon the defendants the duty of proving reasonable care as to the accuracy of statements in the registration statement. By the time the Act was adopted the general consensus was that not all individuals would be held to the same standard of care, that the degree of reasonableness depended upon the importance of each individual's place in the distribution process and the degree of protection the public expected from him.[119]

Also, at the time of adoption, there were express statements to the effect that not all directors should be held to the same standard,[120] nor should all underwriters be held to the same standard as the managing underwriter.[121] Some of these authors felt that as to the outside directors, the standard should be kept to a bare minimum. There is no doubt but that long standing business practices had influenced this position. The flavor of this strong attitude can best be gleaned by the following statement:

115. Statement of T.G. Meeker, *BarChris* Conference, *supra* note 105, at 573, 581-82.
116. Stevens v. Hoare, *supra* note 90.
117. Adams v. Thrift, *supra* note 88.
118. H.R. Rep. 85, 73d Cong., 1st Sess. 26 (1933).
119. H.R. Rep. 85, 73d Cong., 1st Sess. 9 (1933).
120. Douglas & Bates, *The Federal Securities Act*, 43 YALE L.J. 171, 193 (1933).
121. Landis, *Liability Sections of the Securities Act Authoritatively Discussed*, 18 AM. ACCOUNTANT 330, 332 (1933), and 3 LOSS, SECURITIES REGULATION 1726 (1961).

> As with the other persons made liable on the registration statement, the risks to directors increase with the size and complexity of the issuer's operations. Furthermore, though there may be some or many directors who do not 'direct' (in the sense that they merely draw prestige and fees from the position) there are a great many, particularly of the larger and more complicated enterprises, who do and yet are not personally familiar with all details of operation. Nor could their services be obtained in most cases if they were required to investigate details of the enterprise. The experience and judgment of men of affairs is of great value to most of our more important corporations. To deprive enterprises of this asset would seem uneconomic in view of the slight gains which may be expected. It is possible to safeguard the accuracy and completeness of the registration statement without subjecting every director to the burden of proof that after reasonable investigation he had reasonable ground for believing and did believe the registration statement to be free from actionable untruths or omissions.[122]

Yet, even in the face of this somewhat prevailing attitude of the day there were premonitions that a change was hopefully to be effectuated as evidenced by the Congress's hope of having persons resign from several boards and confining their efforts to a few boards where they would actually direct.[123] The philosophy in holding all directors liable, notwithstanding possible distinct standards among them, is best evidenced by the following excerpt from a 1933 Senate report:

> If one of two presumably innocent persons must bear a loss, it is a familiar legal principle that he should bear it who has the opportunity to learn the truth and has allowed untruths to be published and relied upon.[124]

---

122. Douglas & Bates, *supra* note 120, at 195-96. The authors qualified this position by suggesting that adequate regulatory legislation is needed for the protection of the corporation and the minorities in cases where directors have used their position merely as a social badge or as an advantageous trading position. They concluded: "It is doubtful, however, if that end has any dominant place in a securities act." *Id.* at 196.

123. *Supra* note 110.

124. S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933). See Note, *Escott v. BarChris Construction Corporation: Section 11 Strikes Back,* 21 STAN. L. REV. 171, 183 (1968).

Although there appears to be no relevant data on the subject, it is probably safe to assume that the practice of electing outside "non-directing" directors to the board, at least prior to *BarChris*, was as widespread as ever due primarily to the vast increase in the number of corporations in existence. To this must be added the vast increase in the number of public offerings where in a majority of cases the company elects or appoints to the board an individual connected with the managing underwriter. *BarChris* notwithstanding, section 11 had not lived up to expectations.

The distinction between the duty of an inside director and outside director is implicitly, if not expressly clarified by the *BarChris* court's treatment of the several directors. First, all the directors who actually engaged in the operation of the corporation's affairs were *presumed* to have had the complete knowledge of one ordinarily in that position. If such knowledge and familiarity is relevant to expertised portions of the registration statement the director will have a correspondingly more difficult task proving he had no reasonable ground to believe that any of the statements contained therein were untrue. This is evidenced by the court's ruling that the chief financial officer and comptroller had failed to establish their belief in the truth of the financials and as a consequence were held liable as to the expertised portions of the registration statement.

As to a reasonable investigation of the non-expertised portions the court was less succinct in making a distinction between the inside and outside directors, ultimately holding them all liable under the same standard based on the fact that none had made an investigation. But again, it would appear that the insider will have a correspondingly more difficult task in sustaining his burden simply because of his familiarity, or presumed familiarity, with the corporate affairs and operation. It might be that nothing short of a wholesale investigation by the insider will relieve him of liability, where as in the case of the outside director a reasonable investigation may be established by a showing that minutes of the parent and subsidiary corporations were read, the major contracts studied, and the account books, order books and other important corporate documents examined. In addition to this, there of course must be a showing by the director that he read and was familiar with the registration statement.

But this may be a too simple reading of *BarChris*, at least as concerns the outside director. One inescapable conclusion must be reached: there must be more than just an investigation, there must be verification based upon personal knowledge and this belies another factor, the vitality of which may have been prophesied by way of dictum as early as 1937, where, in *Martin v. Hull*,[125] the court, after discussing the *requirement of reasonable investigation* stated:

> All these [directors, etc.] are liable to the buyer not only if they cannot prove they did not know of the flaw in the information offered the public but also if they cannot prove that they could not have found that flaw 'after reasonable investigation'. . . . *This throws upon originators of securities a duty of competence as well as innocence.*[126]

A proper investigation is going to require an expertise on the part of the director of the operation of the business. One could not intelligently examine contracts, factoring agreements, or for that matter the minutes of the parent and subsidiary corporations and hope to glean their significance without some sophistication. The facts of *BarChris* illustrate this point well. For instance, Judge McLean states that had the minutes of the subsidiaries Bridge and Yonkers Lanes been read the fact that BarChris was about to operate them would have been disclosed.[127] If this fact were known to the two outside directors, Auslander and Rose, would it have had an impact upon them? The court held that the failure to disclose the possibility of operating these two alleys was a material misstatment in that BarChris was not described as an operator of alleys in the description of business portion of the registration statement.[128] Further, Bridge and Yonkers were included in sales for the first quarter of 1961 (the unaudited figures) and thus caused an overstatement in sales which was held to be a material misstatement.[129] The Bridge transaction was a complex transaction where BarChris ultimately acquired the stock of the purchasing company.[130] There had in fact been a contract in 1960, and a portion of the selling price of that contract was held to be properly included in sales in the 1960 figure under the percentage of completion method. How were these two directors, one of them an engineer, to know that

125. *Supra* note 109.
126. *Id.* at 210 (emphasis added).
127. 283 F. Supp. at 691.
128. *Id.* at 678.
129. *Id.* at 668.
130. *Id.*

the acquisition of the Biel Land Development Co. stock (the original purchaser of Bridge) converted the transaction into an intracompany one as of March 31, 1961? With Yonkers Lanes the court stated that the executive committee minutes on March 18, 1961, would have indicated that there was no contract for this center, but it wasn't until May 4, 1961, that BarChris formed a subsidiary which eventually operated Yonkers.[131]

Whether the outside directors would have discovered these flaws is a matter for speculation. Suffice it to say for the moment that sophistication and competence may well play a major role in determining whether a sufficient investigation had been made. This belief is grounded on a literal interpretation and analysis of section 11(c) and its attendant trust law implications. A reasonable investigation is that required of a prudent man in the management of his own property. Could a director, after having shown a relatively extensive investigation, state to the court that the lack of business acumen or lack of acumen in the particular business was the cause of his failure to uncover the flaws? Would this not be a request to stretch the mandate of section 11(c) beyond proportion?

It will not be argued here that both insiders and outsiders should, or could, be held to the same standard; obviously, the insider is going to have a much heavier burden to carry, and justifiably so. But nevertheless, such hypothecation can be dangerous and misleading, as is every generalization. The fact that the insider has a heavier burden will not lighten the load to be carried by the outsider.

It seems to the writer that Judge McLean was correct in initially holding each director, new or old, to the same standard, *increasing* the burden of each according to his exposure in preparing the registration statement and his exposure to the machinations of the business. Neither inside nor outside director can claim a lack of expertise or competence as regards ordinary business procedures, but the outside director may escape liability on the uniqueness or complexity of a particular transaction if he can show that a reasonable investigation would not necessarily have disclosed the flaw, whereas an insider, involved directly in the transaction, could not avail himself of this defense.

The above reasoning would seem to hold especially true to the attorney-director situation, although the *BarChris* court had

131. *Id.*

little difficulty in finding that the attorney-director failed to do even some of the things that the ordinary outside director should have done.

Two points ought to be emphasized. One, the director-attorney, who also prepares the registration statement, is in a precarious position, in that he will probably have to prove that he was quite familiar with all aspects of the business, and his lack of competence or knowledge will not only prove to be no defense, but rather will emphasize his duty to be more sophisticated as to the corporation's affairs. Two, the director-lawyer who does not prepare the registration statement probably stands in the same shoes as any other outside director, unless it is shown that he, because of his professional acumen, had acquired a more particularized knowledge of the corporation. A collateral question is raised as to investor reliance upon the particular director because of his professional status. Will potential investors glean from the prospectus that the director is an attorney as well and does this result in added reliance? Will the ordinary investor assume that when playing the role of director the attorney lends his professional criticism to transactions of the corporation or gives his professional blessings to those transactions?

Lastly, does his very position of trust in the community as an attorney carry over in giving respectability to the board and thus add dignity to the prospectus? These questions highlight the dangers facing not only attorney-directors, but others as well who are possessed of special qualities.

In a recent article the contention was made that the ordinary investor would not rely on a director who had been elected to the board only one month before the effective date of the registration statement:

> These men had a most peripheral place in the scheme of distribution and were not really in a position to afford the investor much additional protection.[132]

This contention belies the fact that an investor may give greater weight to the name, reputation, expertise or business acumen of the director, rather than to the length of his service. Indeed, the name of a respected financial figure would seem to have a greater effect upon the investor than would the name of

132. Comment, *BarChris: Due Diligence Refined,* 68 COLUM. L. REV. 1411, 1417 (1968).

some obscure hard working, well-informed director. Congress has already indicated that investor reliance dictates the importance of the role to be played by each individual in the distribution process.[133] To possibly avoid this potential added burden it is suggested that the prospectus specifically indicate what directors are "outside", what it is that they actually contribute to the corporation by way of guidance, and if they possess special capacity whether this capacity is being specifically utilized by the corporation.[134]

2. *The Underwriters' Duty to Investigate.* Judge McLean's decision, so far as it concerned the underwriters in *BarChris*, should have come as no surprise; indeed, unlike the outside directors, the underwriters were specifically slated much earlier than *BarChris*, to have a special role in a public offering,[135] and this role was particularly characterized in two prior SEC decisions.

As early as 1953, in *Charles E. Bailey and Co.*,[136] the Commission had stated that underwriters must be particularly careful in verifying the issuer's self serving statements, especially when there is a new and speculative venture to be financed, and especially when the statements concerned the issuer's operations and prospects.

In *Bailey*, the underwriters' defense was based on a preliminary investigation of the company's affairs with the contention that such investigation was sufficient to satisfy the underwriters' duty. A further contention was that the underwriters were not responsible for the contents of the prospectus, since it contained information supplied by the issuer, on which they were entitled to rely. The Commission specifically rejected these contentions.[137]

---

133. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933). *See* note 119 *supra.*

134. Unlike those of the officers, the past business positions of directors need not be indicated in the registration statement. *See* form S-1 (Registration Statement under the Securities Act of 1933) Item 16 (rev. 1955) 1 CCH Fed. Sec. L. Rep. ¶ 7123, at 6208. Note, *Escott v. BarChris, supra* note 96, at 918, n. 51. The article makes the suggestion that new directors not be selected until after the public offering. *Id.*

135. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). Therein underwriters were characterized as fiduciaries, responsible for a high standard of care, competence, and honesty.

136. 35 S.E.C. 33 (1953).

137. For an extensive discussion on the *Bailey* case with emphasis on the Commission's treatment of the underwriter's defense see Israels, *Edited Selections from the San Francisco Meeting,* 18 BUS. LAW. 27, 32 (1962).

In *The Richmond Corporation*,[138] the Commission made it even more clear that reliance upon the issuer's representations did not satisfy the requirement of a diligent investigation into the issuer's business and a verification of the accuracy of the information contained in the prospectus. The underwriters' investigation in *Richmond* consisted of visits to two of the issuer's three tracts of land, an examination of the stockholders' list and the acquiring of a credit report on Richmond; "as to all other matters in conjunction with the registration statement the underwriters apparently relied only on representations of registrant's management. Such limited investigation clearly did not measure up to the degree of care and diligence required of an underwriter."[139]

Although *Bailey* and *Richmond* were actions dealing with section 15(b) of the Securities Exchange Act[140] (broker-dealer revocation) and section 8(d) of the Securities Act[141] (stop order proceedings) respectively, the standards enunciated in both are and should be equally applicable to actions brought civilly under section 11.

> If a failure to make a reasonable attempt to verify the data presented to the underwriters by the company officers is a sufficient basis for revocation of a broker-dealer registration, it certainly seems sufficient to constitute a basis for imposing the statutory liability of section 11.[142]

The *Richmond* case provides even a richer source for comparison. The Commission there was directly concerned with a false registration statement and ultimately issued a stop order prohibiting the stock from being issued. The Commission, as above noted, made a finding that the underwriters had failed to perform their duty properly.

That *Richmond* and *Bailey* were precursors to *BarChris* leaves little to speculation. Whether adjustments were made by the underwriters as a consequence leaves a great deal to speculation.[143]

138. 41 S.E.C. 398 (1963).
139. *Id.* at 405.
140. 15 U.S.C. 78o(b) (1964).
141. 15 U.S.C. 77h(d) (1964).
142. *Supra* note 132, at 1418.
143. From the survey taken of counsel, *infra*, there was every indication that *Richmond* had no impact whatsoever.

The pronouncements in the two cases were in no way revolutionary, but rather were dictated by well-established guidelines. In 1933 Congress defined the standard to be maintained by underwriters.[144] Viewed retrospectively, in light of the policy statements of Congress, and the policy considerations advanced by the SEC, there seemed to be little foundation for assuming that the underwriters would be held to a lesser standard under section 11; yet, the underwriters in *BarChris* attempted to argue that the lesser standard existed by virtue of state corporation law,[145] making no attempt to overcome the broad postulations set forth in *Bailey* and *Richmond.*

An underwriter, by lending his name and his reputation to the offering, solicits from the public reliance and trust. By his involvement the implication arises that an investigation has been made by the underwriter, an investigation sufficient to satisfy the underwriter as to the integrity and honesty of the issuer and as to the accuracy and adequacy of the prospectus.[146]

---

144. *Supra* note 135.

145. 283 F. Supp. at 696. *Supra* notes 93-95, and accompanying text.

146. Several lay books are written wherein the underwriters' role in investigation for a public offering is described. D. H. BELLEMORE, INVESTMENTS: PRINCIPLES, PRACTICE AND ANALYSIS (2d ed. 1966) describes the extensiveness of the investigation to the general investing public:

> The Preliminary Investigation. If the originating investment banker has not dealt previously with the issuer he may decide to make a brief preliminary investigation, which may save the expense of a complete investigation if the issuer is found to be unsatisfactory. This investigation will include a review of the industry situation and the company's position in the industry based on information that is readily available. If the preliminary study is favorable and the investment banker believes that further investigation is justified he will request assurance from the issuer that he is to have first priority for the proposed underwriting. *With this in hand, he will initiate a complete, thorough, and far reaching investigation.*
> The Complete Investigation. The complete investigation is much more comprehensive and may be broken down into an accounting and financial section, an engineering section, a legal section and a general section. *Not only is the staff of the buying department fully utilized,* but outside accountants, engineers, and lawyers are frequently called upon to supplement the work of the buying staff in the case of large issues. Frequently much of the information is handled by representatives of the issuer *and then checked by the originating investment banker.*

*Id.* at 203 (emphasis added).

*See also* as to the underwriter's reputation and public reliance, C. ISREALS & G. DUFF, WHEN CORPORATIONS GO PUBLIC 43 (1962); BADGER, TORGERSON & GUTHMAN, INVESTMENT PRINCIPLES & PRACTICES 89 (1961); ROBINSON, GOING PUBLIC 20-21 (1961); DONALDSON, CORPORATE FINANCE 398 (1957); Gourrick, *Investment Banking Methods Prior to and Since the Securities Act of 1933,* 4 LAW & CONTEMP. PROB. 44, 46-47 (1937); Douglas & Bates, *Some Effects of the Securities Act of 1933 Upon Investment Banking,* 1 U. CHI. L. REV. 283-84 (1933); *cf.,* United States v. Morgan, 118 F. Supp. 621, 655 (S.D.N.Y. 1953).

Even as an ordinary business venture between the underwriter and the issuer, especially in a complete undertaking, where full financial responsibility is placed with the underwriter, as opposed to a "best efforts" underwriting, the underwriter should do no less than thoroughly investigate for its own financial safety irrespective of investor considerations. As indicated in *Richmond*, citing *United States v. Morgan*,[147] an antitrust suit under the Sherman Act, wherein the defendants jointly issued a statement as to the standards and practices of investment houses:

> The first step of the investment banker, . . . is to make an investigation of the company, including among other things its corporate and capital structure, its present and future financial needs and its financial condition. The investigation itself is usually very extensive and detailed, and involves extended conferences with the issuer's officers, counsel, and accountants. It involves a complete review and analysis of the financial statement of the issuer for a considerable period in the past, and it involves going behind such statements to appraise the true value of the assets shown.[148]

Judge McLean, although stating that no rigid rule could be set concerning the degree of investigation to be made by the underwriters,[149] made it crystal clear that the underwriters' position was adverse to the issuer and as such no reliance could be placed on any of the representations of the issuer's officers.[150] Thus, it is reasonable to assume that in order to follow the court's mandate a complete independent investigation must be made by the underwriters. Holding the underwriters to this high standard does not make them "guarantors";[151] quite to the contrary, a reasonably diligent investigation into "material" areas, with independent verification of management's representations could satisfy section 11(b), absolving the underwriters from liability even as to misrepresentations not uncovered. Of course, this assumes that the investigation and verification was performed in a competent manner. But no investigation or only a partial investigation will automatically result in liability at least to the extent that the underwriters will be liable for all misrepresentations which a "proper" investigation would have uncovered.

147. 118 F. Supp. 621 (S.D.N.Y. 1953).
148. *Id.* at 655.
149. 283 F. Supp. at 697.
150. *Id.* at 696.
151. S.E.C. Release No. 3-45, Sept. 22, 1933, 11 Fed. Reg. 10947.

Further, since it is speculative whether such investigations "could" have in fact uncovered the misrepresentation doubt will usually be resolved in favor of the plaintiff on the presumption that an investigation into those matters "would" have revealed the inaccuracy.

The danger to underwriters, and to outside directors as well, as previously pointed out, is that they may be liable for misrepresentations that reasonable and diligent investigation may not have uncovered. Thus, the degree of investigation is largely for personal determination. The underwriter must investigate those areas which he knows or feels are "material" and on which the investor will place reliance.

Judge McLean held the "group" underwriters liable for Drexel's failure to conduct a reasonable investigation.[152] The facts were indisputably clear that the underwriters conducted no investigation apart from the managing underwriter. The decision came as no shock to the group for two reasons: one, section 11 makes no distinction between the managing and other underwriters; and two, it is common practice, when there is more than one underwriter, which is the usual case, to have the managing underwriter conduct the entire investigation.[153] The only obligation of the group is to contribute to the financing, that is, to assume the obligation for a portion of the offering. The group is usually resolved to stand or fall with the managing underwriter as the case may be. As we shall see later, in the survey, this attitude has not changed appreciably.

The only "investigation" undertaken by the group was at the customary due diligence meeting,[154] wherein the underwriters questioned certain of the officers, the issuer's counsel, and the accountant. The due diligence meetings are thought to be worthless by many, serving only to give underwriters selling information about the company.[155]

Whether it is more profitable for the group underwriters to stand or fall with the lead underwriter is again a highly specula-

152. 283 F. Supp. at 697.
153. *See* note 146, *supra.*
154. *See* Trial Memorandum No. 2 of Defendant Underwriters and D. B. Coleman at 73-74, Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), and Note, *Escott v. BarChris, supra* note 96, at 911, n. 20.
155. *See* Symposium of the Section of Corporation, Banking and Business Law of ABA, *Current Problems of Securities Underwriters and Dealers,* 18 BUS. LAW. 27, 42-43 (1962); *BarChris Conference, supra* note 105, at 542-43.

tive question, for in *BarChris* one of the group underwriters contributed $70,000 as its portion of the settlement agreement. Perhaps in the face of this, independent investigation or at least representative participation in the investigation might prove to be desirable for, again, two reasons:

1. Group underwriters will probably not be held to the same standard of investigation as the managing underwriter providing they undertake to make some investigation. Their names on the prospectus no doubt elicit investor reliance and this alone would dictate some duty. Certainly no investigation would prove to be fatal in every instance.

2. The more dangerous question of whether the group underwriters would be liable for failing to investigate, notwithstanding the fact that the managing underwriter has sustained its burden, was left open by the court since there was no necessity to make that determination.[156] The fact that the court expressly recognized the problem lends weight to the dangerousness of the situation.

Some suggestions as an alternative to not investigating seem apropos. Since the standard applied to them will probably be lower, the group underwriters may be able to sustain their burden by showing a concerted effort to check on the actions of the lead underwriter and its counsel, and by requiring a more concentrated due diligence meeting wherein all of the key officers, including all directors and division heads, would be required to attend. At this meeting the entire S-1 should be reviewed.

As an alternative, a concentrated meeting should be had prior to filing with a review meeting just before the effective date, covering all of the red line changes. Of course, the underwriters should attend, not just their analysts. Further, to avoid liability for failing to investigate, where the lead underwriter is exonerated, some agency relationship should be worked out so that it is clear that the lead is performing the investigation on behalf of all of the underwriters. Under the section 11(c) trust theory, this may, given some investigation, be a proper delegation of duties.

There is practical support for the aforementioned suggestions and conclusions. It is common knowledge in the investment community and among many investors, that the managing under-

156. 283 F. Supp. at 697, n. 26.

writer usually assumes the responsibility for the investigation. Secondly, it would seem highly impractical for ten, twenty or thirty separate underwriters to independently investigate into the issuer's affairs. This, too clearly, would not only be an unreasonable burden on the underwriters with the concomitant waste of capital and manpower, but would also constitute a burden on the issuer, its officers, and the company counsel.

The issue of reliance by the investing public is once more called to mind. While there surely is reliance based upon the reputations of the various group underwriters,[157] the reliance probably is not as great as that placed upon the managing underwriter. The role of the group in the distribution process should also be analyzed. That they play a major role is not in dispute for they finance and distribute the securities. But since their role in the investigative process is hampered by practicality this message should be borne to the investors by way of the prospectus so that reliance will not be so great.

In the last analysis it is evident that the best solution would be found in further legislation or SEC action to delineate the duties of the managing and the group underwriters. This necessity is further emphasized by the limited pronouncement of the court concerning the delegation of investigative duties to counsel by the managing underwriter[158] and the total lack of pronouncement as to the propriety of group underwriters' delegation to the managing underwriter. The flavor of the court's language could lead one to believe that perhaps a delegation of duties is permissible and that had counsel performed an exemplary task of investigation the managing underwriter would have escaped liability, thus perhaps exonerating the group underwriters.

As previously indicated, there may be a delegation of the performance of acts which it is unreasonable to require of the investigator and there may be reliance and consequently a full discharge of responsibility if the delegate's performance is reasonable, in light of all the circumstances.[159] The Report further indicates that delegation might be justified when the delegate possesses skills or resources not possessed by the delegator.[160] In any event the court failed or refused to expressly consider the question of delegation.

157. *See* note 146, and accompanying text, *supra.*
158. *Supra* note 156, at 697.
159. *Supra* notes 89-90, 96-100, and accompanying text.
160. H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933). *See also* note 89, *supra.*

There were two possible bases for the court's ruling the underwriter bound by counsel's failure to properly investigate and concomitantly rejecting the delegation theory. First, counsel in its opinion letter disclaimed any effort to verify the data presented to it by the issuer.[161] Reliance here on the delegate's performance would certainly be unreasonable in light of the fact that the underwriter made no attempt to verify either. Secondly, perhaps the court, notwithstanding its language, took a negative view to a delegation of duties where the same was not warranted by any special circumstances indicating that counsel was better equipped to investigate than the underwriter. Indeed, in the instant case, as well as in the usual situation, the attorney usually stands in no better position than the underwriter in terms of business, analytical, or investigative expertise. In fact, the underwriter usually has more facilities, manpower, and experience to handle these matters. Finally, this position may be strengthened by virtue of the fact that the delegate was one not contemplated as a defendant under section 11 and thus not directly accountable for his actions to plaintiffs under a section 11 action.

A recent article takes the position that the court relied on the second basis for its determination.[162] It is submitted that the court's language does not carry this weight nor, it is further submitted, if the question arises again, will the court look to the unreasonableness of the delegation in preference to viewing whether the performance was satisfactory. If satisfactory investigation is not shown by the defendant recovery will be forthcoming irrespective of who performed the task, delegate or delegator; conversely, if a satisfactory investigation is proven it should not matter whether it was performed by the delegate or

---

161. 283 F. Supp. at 695.

> In the course of the preparation of the Registration Statement . . . we have had numerous conferences . . . and we have raised many questions regarding the business of the Company. Satisfactory answers to such questions were in each case given us, and documents we have requested have been supplied. We are of the opinion that the *data presented* to us are accurately reflected in the Registration Statement and Prospectus and that there has been omitted from the Registration Statement no material facts *included in such data.* Although *we have not otherwise verified* the completeness or accuracy of the information furnished to us . . . we have no reason to believe that the Registration Statement or Prospectus contains any untrue statements . . . . (emphasis by the court).

162. Note, *Escott v. BarChris, supra* note 96, at 914.

the delegator. The article agrees to this as the outcome under the trust theory.[163]

As stated previously, this point has signal importance both to the managing underwriter and the group, for heavy reliance, as a matter of ordinary business practice, is placed upon counsel by the managing underwriter, and collaterally, great emphasis and reliance are placed upon the manager by the group. Again, and it cannot be too strongly emphasized, that total reliance in every instance will be unwarranted. At best, only "acts", as indicated by the House report, can be delegated.[164]

*3. The Accountants' Duty to Investigate.* The passage of section 11 brought the accountants' liability into clear perspective, expressly excluding the previous common law requirements of privity and scienter. Thus "the revolutionary change to be wrought by legislation" as suggested by Judge Cardozo in *Ultramares Corporation v. Touche*,[165] was indeed so wrought in 1933. But the standard of care and competence supposedly imposed on the accountants was severely weakened in an action under section 11 against accountants in *Shonts v. Hirliman*[166] in 1939.

Under the common law a third party could not sue an accountant for negligence, but could sustain an action in deceit if fraud was alleged and proven. In this regard an inference of fraud for purposes of the deceit action could be supported by sufficient evidence of gross negligence.[167] The *Shonts* decision appeared to have carried section 11 no further than the common law by holding the accountants to a very low standard of care. The material omission in the registration statement, found by the *Shonts* court, was the failure to note that the issuer had obligated itself to a yearly contingent liability of $35,000 on a lease, whether or not the property covered therein was used or not. The lease was entered into a week after the certified financial statement date, but before the effective date, yet no mention of the lease was made in a post effective amendment filed by the issuer. Since no concrete agreement was reached before certification,

163. *Id.* at 915.
164. *See* RESTATEMENT (SECOND) OF TRUSTS § 171, comment c (1959).
165. 255 N.Y. 170, 187, 174 N.E. 441, 447 (1931).
166. 28 F. Supp. 478 (S.D. Cal. 1939).
167. *See* State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938). But these common law notions are rapidly changing. *See* Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967) and Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968).

and since the agreement was not called to their attention, nor could they have discovered its existence by perusal of "the books at their disposal", the accountants were exonerated. As noted by several authorities, both within and without the accounting profession, the court applied an uncommonly low standard to the accountants, indeed, a standard below what was customary in the profession, and thus has been highly criticized.[168]

Although *Shonts* appeared to do no more than echo *Ultramares*, and notwithstanding the fact that it was never expressly overruled, neither the accounting profession at large, nor the accountants in *BarChris*, relied on it as authority. Indeed, stricter standards concerning post effective certification investigation, were enunciated early by a noted accountant,[169] postulated by the accounting profession itself,[170] and put into practice by the accountants through the vehicle of the S-1 Review.[171]

Of notable significance is Judge McLean's treatment of the problem. While recognizing that the procedures and programs employed by the accountants in *BarChris* conformed to generally accepted auditing standards, he found the accountants' actions did not comport with those standards in that the investigation made was minimal and did not follow the established program for an S-1 Review. Thus, *BarChris* did not reestablish "the standards imposed on accountants at the level recognized in their profession";[172] it merely recognized them and found that they had been violated in this instance, something which the *Shonts* court failed to do.

One interesting facet of the decision was the court's accentuation of "performance" by its reference to the inexperience of the

168. *See* 3 LOSS, SECURITIES REGULATION 1733 (1961); Comment, *Accountant's Liability to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 158 (1967); Note, *Civil Liability Under the Federal Securities Act*, 50 YALE L.J. 90, 98-99 (1940); Note, *Accountants' Liability for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967). See also Note, *Escott v. BarChris Construction: Section 11 Strikes Back*, 21 STAN. L. REV. 171 (1968), citing at 183 Rappaport, *Accountants' Responsibility for Events Occurring After the Statement Date: The Shonts Case*, 95 J. ACCOUNTANCY 332 (1953).

169. *See* Rappaport, *Accountants' Responsibility for Events Occurring After the Statement Date: The Shonts Case*, 95 J. ACCOUNTANCY 332 (1953).

170. Committee on Auditing Procedure, American Institute of Certified Public Accountants, *Statement on Auditing Procedure No. 33*, AUDITING STANDARDS AND PROCEDURES 75-80 (1963).

171. *Id.* For an excerpt of Auditing Procedure No. 33, showing what should be done during the post statement period see, A.A. Sommer, Jr., *BarChris Conference, supra* note 105, at 593, Appendix B, page 609.

172. *See* Comment, *supra* note 132, *at* 1419.

accountant responsible for the bulk of the auditing work. Was the court intimating that in cases to come, when it is shown that the correct procedures were properly followed, there may still be liability based on negligence for failure to have discovered the errors during the investigation? Stated otherwise, an analysis of the accountant's competence, experience and expertise might be the ultimate consideration in determining whether the accountant "knew or should have known" of the misstatement or omission. If this be so, then section 11 would be brought into line with the English Companies Act, which requires that competency be expressly proven by the expert.[173]

One more interesting point should be noted about the *BarChris* case and accountants. While the court approved of the S-1 Review schedule used by Peat, Marwick (fashioned after the Review suggested in Statements on Auditing Procedure No. 33),[174] it indicated that maybe more should be required than the generally accepted auditing standard set forth therein. Neither Procedure No. 33, nor the Peat, Marwick procedure required any external inquiry by the accountants during the S-1 Review, unless, of course, during the course of the internal investigation something was discovered which would require external investigation, yet Judge McLean stated that had inquiry been made to the factors the accountants would have discovered most of the customer delinquencies and a listing of the same in the prospectus would have cured a material misrepresentation. This external inquiry was without the scope of the S-1 Review, but as one expert intimated, there are circumstances which perhaps would require an external investigation, although the same usually is not done.[175]

Since the accountants are responsible for their figures as of the effective date and not the date of certification and since they need not endure a complete audit in the review, perhaps an external investigation would not be too demanding. Procedure No. 33 ought to be amended to include the same.

---

173. *See* notes 79 to 83, and especially note 84 with the accompanying text, *supra*.
174. *Supra* notes 170-71.
175. *See* A.A. Sommer, Jr., *BarChris Conference, supra* note 105, at 604-07. For a discussion of the use of the standards developed by the American Institute of Certified Public Accountants see, Note, *Accountants' Libility for False & Misleading Financial Statements,* 67 COLUM. L. REV. 1437, 1464-68 (1967).

## V. THE IMPACT OF BARCHRIS — A MEASURE OF THE REACTION OF THE INVESTMENT COMMUNITY AND SOME PRACTICAL IMPLICATIONS

Paradoxically, *BarChris* raised more crucial questions than it decided. The factual setting made the ultimate determination relatively easy, yet the decision offered only skeletal guidelines for the investment community to follow. The significance of the decision itself was in dispute with many people stating that *BarChris* said nothing new; others were more pessimistic. To best gauge the impact of *BarChris* a survey was taken of members of law firms in four key cities, representing three major sections of the country.[176] The result of the survey showed significant reaction and distinct attitudinal changes based not only on *BarChris*, but on other recent cases as well, such as *Globus v. Law Research Service, Inc.*[177] As a consequence, and since *Globus* has a distinct relationship to *BarChris* and section 11,[178] the survey questionnaire was revised early in the survey to include questions concerning indemnification and insurance. While the issue of indemnification was not before the *BarChris*[179] court it is thought to be vital to the total spectrum of public financing.

176. The survey included 10 firms from Los Angeles, Miami, Boston, and New York. Approximately 25 attorneys were polled.

177. 287 F. Supp. 188 (S.D.N.Y. 1968); *aff'd*, CCH Fed. Sec. L. Rep. ¶ 92, 474 at 98,234 (2d Cir. 1969).

178. *Id.* at 199.

179. There were several cross claims in *BarChris*, but none were lodged by the group underwriters against the managing underwriter, nor by the managing underwriter against BarChris. Interestingly enough, no cross claim was filed by the managing underwriter against its counsel. The cross claims were as follows:

1. The Trustees in Reorganization (*supra* note 55) for BarChris Corp. charged Vitulo, Pugliese, and Russo, the insiders, with fraud by their attempting to obtain repayment of loans made by them to the corporation and for attempting creditor preference for others in close association with them.

2. Rose, an outside director, charged Peat, Marwick & Co., and its agent Kirscher, with negligence and misrepresentation in persuading Rose to accept a directorship with BarChris. (Rose pleaded *State Street Trust Co. v. Ernst, supra* note 167, wherein it was held that a director has a right to sue others if they misrepresent, where the director relied upon their position and statements.) The contention was that common law fraud and misrepresentation were not abolished by the adoption of the 1933 Act. See *Trial Memorandum of Defendant Rose In Support of Motion to Plead Over Against Certain of the Defendants.* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (Pleadings File).

3. All the investment bankers cross claimed against Vitulo, Russo, Pugliese, Kirscher, Grant, and Peat, Marwick & Co.

4. Kirscher and Trilling claimed over against Vitulo, Russo, Pugliese, Birnbaum, Grant, and Peat, Marwick & Co.

5. Vitulo and Pugliese claimed over against Kirscher, Trilling, and Peat, Marwick & Co.

To best gain a perspective of the discussion to follow, the questionnaire is set forth below in entirety. It should be kept in mind that the questions are broadly based and that much information related hereafter was wrought from informal discussion initiated from one question or another. Further, the survey does not purport to be definitive in nature, nor does it claim to have isolated the various personality, practice sophistication, or other variables; its primary purpose was barometric in nature, to ascertain the changes initiated by *BarChris* and to hopefully glean the prevailing attitude in the industry.

SURVEY QUESTIONS

1. Have you had occasion to represent, in connection with a public offering, one or more of the following: a. Issuer b. Underwriter c. Director d. Any officer of the issuer? Before or after April, 1968?

2. Have you ever been consulted by an accounting firm or engineer in connection with matters concerning a public offering? Before or after April, 1968?

3. Are you familiar with the decision *Escott v. BarChris Construction Corporation*?

4. Are you familiar with the SEC decision of *In re Bailey* and *In re Richmond Corporation*? At approximately what date did you become familiar with them?

5. Do you have a written procedure which you follow when making an investigation under section 11? a. Was this written procedure in effect before April, 1968? b. If no written procedures, what guidelines are followed, if any? Have they changed since April, 1968?

6. Are questionnaires given to the officers, directors, employees, or controlling stockholders of the issuer? If so, has the content of these questionnaires changed since April, 1968?

7. What is the usual number of attorneys working on preparation of registration statement or in conducting the investigation? Has this number changed since April, 1968?

8. What is the usual makeup of the attorneys in terms of experience? Has this changed since April, 1968?

6. Birnbaum cross claimed Vitulo, Russo, Pugliese, Kirscher, Trilling, and Peat, Marwick & Co.
7. Grant claimed over against Peat, Marwick & Co., as did Auslander.
No determination of any of these claims were made, the court having reserved ruling. In the interim the defendants settled.

9. Are the same attorneys usually appointed to work on all public offerings? Has this changed since April, 1968?

10. Approximate the number of meetings held with the issuer stating who is usually requested or required to attend. Has this changed since April, 1968?

11. Are due diligence meetings required; if so, how many and when are they held in approximation with the effective date of the registration statement? Has this changed since April, 1968?

12. What is the number of cold comfort letters required by you? Has this number changed since April, 1968?

13. State briefly and in general terms what your investigation consists of, naming what you would emphasize the most. Has this changed since April, 1968?

14. Do you work closely with counsel for the other parties involved in the public offering?

15. Have you standard instructions to give to the issuer, officers, directors, or underwriters with respect to the disclosure necessary in a registration statement and as to their respective duties? If so, how are they delivered: a. conference b. written c. informally?

16. If you represent an issuer or underwriter would you now require that all interim figures be certified by the accountants?

17. If you represented both issuer and either an inside director or officer of the issuer would you suggest that the director or officer obtain other counsel for the public offering?

18. If you represented an underwriter would you now advise one of the partners of the underwriting firm against joining the board of directors of the issuer? If not, would you advise that he retain other counsel for the investigation?

19. If you represented a nominal or outside director would you advise that he resign from the board before the offering? Would your answer be different if the director were an attorney, analyst, or other professional?

20. Do you as attorney have any contract, agreement, or understanding with your underwriter or issuer clients as regards your liability in connection with the investigation? Has this changed since April, 1968?

21. Do you think it advisable for every person liable under section 11 to undertake his own independent investigation in connection with a public offering?

22. If you represented an underwriter, other than the managing underwriter, would you suggest an independent investigation for that underwriter? What do you think his participation, if any should be?

23. Would you suggest to your client that he obtain insurance with respect to the particular offering?

24. Are you familiar with the *Globus v. Law Research Service, Inc.* decision, particularly with the pronouncement concerning indemnification of the underwriter? If not, what are your views as to the validity of indemnification agreements in the event of liability for a false or misleading prospectus?

25. If you are familiar with the *Globus* decision do you think it will be expanded to exclude all indemnification agreements made in connection with a public offering?

Some general notions were readily gleaned from the data:

1. All firms were in agreement that a reevaluation or revamping of investigation procedures was in order as a result of *BarChris*, and in all instances either the "old" procedure was rejuvenated or a specific procedure was developed. It is interesting to note that where the response was "rejuvenation" there was no written procedure followed and in most cases none adopted. (See q.5.) For those firms creating a specific written procedure to follow, either they formulated their own, or adopted, with room for modification, one of the several checklists that have been published.[180]

Some interesting "informal" guidelines were utilized by one firm representing an issuer:

> 1. Spend three or four days with the company making up the first draft of the S-1. 2. Don't spend too much time with the president of the company, but rather seek out the one who is most familiar with the company, other than the president. Make sure it is not the largest stockholder either and never the vice-president in charge of sales. All of these individuals will try to "sell" you and you will never change their posture. But you must

180. *See* Isreals, *Offerings of New Securities,* 18 BUS. LAW. 27, 37 (1962) and Isreals, *Checklist for Underwriters' Investigation-Addendum-1968-Escott v. BarChris Construction Corp., Selected Articles on Fed. Sec. Law,* ABA CORPORATIONS, BANKING AND BUSINESS LAW SECTION 65 (1968), or Prentice Hall, *How to Guard Against the New Dangers That Face Corporate Officers, Directors, Accountants, Lawyers and Others Under BarChris and Related Cases* (printed for the ABA National Institute 1968).

keep in mind that there must be reliance on someone, notwithstanding *BarChris*, for in order to read the "material" contracts and minutes you must get them all. The best individual is usually the treasurer or secretary. Seek out the one who seems most truthful. 3. Go over the first draft with designated truthful person. The first meeting is with a view to making the second draft and you need not include all officers or underwriter. 4. The second meeting with the second draft is big and must include the president, vice-president, treasurer, chief financial officer, accountants, key personnel and the underwriters. And of course the accountant. This usually takes at least two days because the president keeps disappearing. At this meeting present the questionnaire to the officers and directors. Give memos to certain individuals stating that they are responsible for portions of the registration statement. This will make them think they are responsible, make them feel important, and consequently make them concentrate on the investigation. 5. The second draft will usually result in the first printed proof. Send it to all accountants, lawyers, officers and directors. At this time send a questionnaire to all big customers and suppliers of the issuer to verify statements. 6. Third meeting is with full group and it results in the second proof which usually is filed.

2. Uniquely enough, only two of all polled had any prior knowledge of the *Bailey* or *Richmond* cases; as a consequence they readily admitted that the same had no effect on their procedures, nor on the type of advice given to their underwriter-clients. (See q.4.) Everyone polled was familiar with *BarChris* to varying degrees. (See q.3.) As previously stated, it was the writer's contention that *Bailey* and *Richmond* were precursors to *BarChris* and that they should have caused a tightening up of procedures on the part of the underwriters, especially when the issue was a new one, and the issuer relatively unseasoned.

3. All firms polled indicated a preference in employing well-known national accounting firms to undertake the independent audit, although it should be pointed out that most counsel for the underwriters stated that the selection was ordinarily not theirs to make. Two significant reasons for the prevailing atti-

tude toward national firms were given. One, local firms tend to be "too local", not having the broad experience desired by most underwriters. To this add the fact that other underwriters are more easily drawn to the group by the presence of a well-known reputable national firm as independent accountant. Lastly, as a selling point to the public the name was invaluable. Significantly, no mention of liability was had in connection with this discussion.

4. With respect to the potential liability of their clients, and of others involved in the underwriting, especially those liable under section 11 directly, almost all firms have taken great pains to drive home the significance of *BarChris*, and the necessity for independent verification predicated upon a complete reading of the registration statement. (See qs. 6 & 15.) This has been accomplished through the use of several vehicles varying from an extensive memorandum to counsel's client (See Exhibit A) to a meeting in which liability was discussed. Most notable of the innovations is the change wrought in the questionnaire to officers, directors and controlling stockholders. In these questionnaires a brief explanation of the *BarChris* decision is now given, along with the suggestion, and sometimes instruction, to read the registration statement and the material contracts. In furtherance of this, specific questions are asked of these individuals pertaining to crucial portions of the registration statement such as the description of the issuer's business and the description of the issuer's competition. (See Exhibit B.) The following is a sample of the additional language and content of the questionnaire:

A. Explanation and Instructions

1. Read the registration statement and state whether it is complete and accurate.

2. Notify all of the potential liability and explain their defenses and duties under section 11. Put in section 11.

3. Have an explanation of who and who is not an expert.

4. Explain what a reasonable investigation is in "prudent man" language.

5. Put in the *BarChris* quote as it relates to new and outside directors.

B. Specific Questions

1. List all unclear statements and incorrect statements and list what you think would be of material interest to an investor contemplating buying this stock. List the section.

2. If you know of any material contracts of the company not listed in Item 31(b) of Part II of the registration statement, please describe the contracts below. (Explain that the SEC states that any contract made in the ordinary course of business should be listed in Item 31(b) and filed as an exhibit *if* any officer, director, promoter, voting trustee, principal security holder, or underwriter are parties; or if the company's business is substantially dependent on the contract; or if it concerns a significant lease; or if it concerns the sale or acquisition of assets; or it is of a nature which investors ought to be informed.)

Lastly, everyone is warned that they are required to keep abreast of all changes and discoveries and report them immediately.

Some firms employed more than one device to communicate the prospect of liability emphasizing at the initial general meeting that all directors should undertake an independent investigation. The extent of such investigation was not indicated.

5. It was the general consensus that due diligence meetings, before *BarChris*, were worthless and a complete waste of time as an investigative tool. The major criticisms were directed to the makeup and the extent of the meeting. The individuals most necessary to the success of the meeting were oftentimes absent. The individuals the underwriters would send were analysts usually trying to obtain selling information. Lastly, the person representing the management of the issuer is always the highly optimistic president who directs most of his optimism toward the analysts. As a consequence only a cursory examination is given to the registration statement, with most of the questioning directed to the president.

There is now a split in the firms as to the value of a due diligence meeting and the split is not an insubstantial one. For instance, several firms have "beefed up" the meeting so that it includes more key personnel from the issuer, and the underwriters were engaged in the investigation, instead of just analysts. The content of the meeting has also been beefed up to include a complete review of the registration statement. In this regard, it should be noted that counsel expressed doubt as to whether this will in fact occur. This was the general thought of those counsel who felt that the meeting would always be a waste of time. (See q. 11.)

Some firms, who represented issuers, indicated that they now require one or two due diligence meetings for the directors. In fact, one firm indicated that it requires three meetings; one at the outset, to inform the directors and officers of their responsibilities and liabilities, the second just before the filing of the S-1, and the third right after the SEC's letter of comment wherein all the red line changes are discussed. It was advised that the managing underwriter attend (or his counsel) and if so invited it was urged by underwriter's counsel that the underwriter attend.

It was interesting to note that some of the firms who still held only an informal due diligence meeting with the underwriters now require a directors' due diligence meeting.

6. There appeared to be unanimity among counsel regarding the impracticality and desirability of having interim figures audited and certified. (See q.16.) No explanation was given other than it would have been unusual to request such an audit. It was the writer's impression that the question of audited interim financials had not been seriously contemplated by counsel and that *BarChris* had not sparked the thought.

7. All of the counsel questioned stated that they had never represented an accounting firm or engineer specifically in connection with a public offering, nor had any of them been consulted in this regard, except one. (See q.2.) The implication that most easily comes to mind is that these experts ordinarily do not seek out legal advice either as to the potential liability, or as to any standard which must be maintained by them when performing their tasks. It is suggested that some provision be made by company counsel to inform them of their responsibilities and liabilities.

8. Question 22 was directed specifically to the role of the group underwriter in the investigation process. Posed in two parts, one concerned with whether an independent investigation should be made by the various underwriters, and the other with the extent of the investigation, if there be any, the response elicited

was singular in nature: no investigation, independent or otherwise, is now undertaken by the group, nor is any recommended. The group underwriters have chosen to stand or fall with the managing underwriter as they have done in the past. There were comments that the group underwriters could do more, but no concrete suggestions were forthcoming, except that they should be told to read the registration statement and perhaps the due diligent meeting could be beefed up.

Since there were expressed doubts as to the validity of the due diligence meeting, as a foundation for establishing due diligence, inquiry was made of counsel as to any alternative measures that could be taken by the group underwriters for their protection. The response was not directed at investigation or verification, but was directed toward reliance upon the underwriters' indemnity agreement with the issuer and on insurance if the same were available for the offering. What seemed clearly evident from the inquiry was that no group underwriter would attempt to establish a due diligence defense apart from that which would have to be proven by the managing underwriter, notwithstanding the fact that Congress and section 11 intended for them to be held to a lesser standard than the managing underwriter, a standard which they could perhaps meet if they so elected.

The following discussion, dealing with the remainder of the questionnaire, shows the various lines of demarcation between counsel.

1. Counsel was not in concert on the question of whether more than one cold comfort letter should be required of the accountants. Most were content to have the usual single letter, but the trend seemed to be toward requiring one just prior to the effective date, with a second being delivered at the closing.[181] (See q.12.)

2. Response to questions 7, 8 and 9, concerning the number and experience of the attorneys preparing the S-1, or conducting the investigation on behalf of the underwriters, varied from one experienced partner and one associate to five experienced drafters (three partners and two associates with from 10 to 20 years experience). The majority of firms had from two to three attorneys engaged in the undertaking, with the complement being one

181. For an excellent example of the "new" cold comfort letter, a product of *BarChris*, see Jordan, *BarChris and the Registration Process,* 22 Sw. L.J. 790, at 807 (1968).

partner, one senior associate and one novice. One firm indicated that if the partner were older, and less prone to vigorous activity the novice would be replaced by a more seasoned associate. Lastly, it was generally stated that major contracts, corporate minutes, and other material documents were not examined by the novice. It was not clear whether this was the case before *BarChris* and the point was not pressed in the discussion. What chores could be entrusted to the novice is unclear as most counsel demurred to the question.

3. While there was general agreement that investigations have become more comprehensive in nature since *BarChris*, there was disagreement as to the exact extent of the investigations and to the methods that should be employed. (See qs. 13 & 14.) Some investigation guidelines were exhaustive consisting of an examination of all substantial contracts, documents, minutes (parent and subsidiary, including all committee minutes), a physical inspection of all property if the issuer was relatively new, inquiry into outside sources such as factors, suppliers, other parties to the major contracts, examination into the complete corporate structure, a thorough check into the background of all top officers and directors, a check into the issuer's general reputation, a complete examination of all financials and notes to the financials, and a thorough examination of the questionnaires received from the directors, officers, and controlling stockholders. To this there were further suggestions:

> 1. Check all financial relationships of the issuer with the third person.
>
> 2. Check previous major contracts to ascertain whether there was any difficulty in payments or delivery.
>
> 3. When reading any minutes check specifically for any reference to any material contracts, transactions, or developments which should be considered for mention in the prospectus or registration statement. (A further purpose for this is to provide for an opinion with respect to the valid organzation and legal existence of the corporation, its stock or other securities or possibly other matters which should be covered in counsel's opinion letter.)
>
> 4. Make a written memo reporting the examination, mentioning by references to contracts, transactions or developments that which seems in any way material or

creates any doubts, legal or otherwise, as a result of an examination of the minutes. This memo should be reviewed by the partner in charge.

If the minute books are incomplete obtain the missing minutes and obtain a certificate from the corporate secretary stating that the minute books are complete.

5. If the issuer makes periodic reports to its stockholders or to the SEC, or any other regulatory agency, these reports should be examined for at least five years preceding the date of review.

6. If any engineering, management or similar special reports describing or evaluating the company's business has been prepared within the past five years the report should be carefully reviewed by counsel and by a representative of the underwriter, and the issuer as well.

7. As regards backlog, all big orders must be checked and if there are thousands of small orders then a check of the filing procedure is in order, along with a sampling check of the orders.

8. Check the validity of real estate leases and titles. If examination is not made then indicate so in the prospectus.

9. Check all financials with the underwriter's analyst, the underwriter, the issuer's top officers, the accountants, and both sets of counsel at a time when all are together and when there is no pressure of time.

10. Update the registration at three crucial times: 1. prior to filing, 2. prior to filing final amendment, and 3. at the closing.

11. Document each step and phase of the investigation.

12. Consult with the accountants at each step of the investigation.

13. Spell out to the client exactly what you have done.

The schism in policy among the ranks of underwriters' counsel while not surprising is interesting, for it was widened considerably by the *BarChris* decision. Prior to *BarChris* underwriters' counsel usually assumed the major role in the underwriters' investigation, with the underwriter undertaking the initial investigation only. This division of labor was clearly dramatized in the *BarChris* case, wherein the underwriter, after his initial investigation, limited his chores to an attendance of a few meetings.

Some firms readily admitted a change in policy since *BarChris*, mainly because of the language employed therein concerning the underwriter's duty, and collaterally, due to counsel's liability potential. These firms now require the underwriter to assume an active role in the investigative process; to be present at every step in the drafting and to actively participate in obtaining verification of all important representations. The underwriter is warned of his responsibility and potential liability and advised that he cannot rely on lawyers or accountants to discharge his obligations. Specifically, he is advised to know the background of all personnel, all business aspects of the issuer, and the corporate structure. Further, he is advised to read all major contracts, all minutes, and all important corporate documents. Lastly, they are advised not to limit their investigation to purely an internal inquiry, but rather to seek outside sources of information.

Placing the responsibility squarely upon the shoulders of the underwriter, state the firms, gives credence and substance to underwriter's counsel's opinion letter, which invariably, as evidenced in *BarChris*, disclaims any attempt at verification of the completeness and accuracy of the information contained in the registration statement.

Those firms which continue to assume the major role in investigation without too much aid from the underwriter, will invariably continue to give the same opinion letter, although one firm indicated that it would deliver two letters to the underwriter: one the formal opinion letter, and the second, describing what had been done in the way of preparation and investigation.

There was no doubt in the minds of counsel, who required their underwriter-clients to actively investigate, that they could incur no liability for failing to thoroughly investigate.[182] They gave two reasons for their position. One, they clearly state at the

182. For a nice treatment of the subject of lawyers' liability to the client or to third persons for material misstatements or omissions in the registration statement see Henkel, *Liability of Counsel for Underwriter, BarChris Conference, supra* note 105, at 641. *Cf., Freeman, Liability of Counsel for Issuer, id.* at 635.

outset that theirs is an advisory role only, with the exception of some legal opinions and two, the underwriters cannot rely upon them totally, especially when advised to actively participate and especially in light of the opinion letter which disclaims verification on the part of counsel.[183] This is clearly within the language of the court treating of the underwriters' unfounded reliance upon its counsel in the face of counsel's opinion letter. (See q.20.)

4. Questions 18, 19 and 21 attempted to treat the problem of the nominal or outside director, and many firms were found to be seriously concerned, notably those firms representing the managing underwriter, for traditionally the underwriter usually placed a partner on the board of the issuer as part of the underwriting deal. The relationship was advantageous from both the standpoint of the issuer and the underwriter for the issuer gained not only prestige by having a sophisticated businessman on the board, but also gained an additional selling point for the stock, while at the same time, the underwriter was placing itself in an advantageous inside position to watch the company. Ordinarily the underwriter-director did not assume too active a role in directing the corporation. Since *BarChris*, *Merrill Lynch*,[184] and other recent cases concerning directors and insiders connected with investment banking firms, the position has become a dangerous one liability-wise not only for the individual director, but for the investment banking firm as well.

Thus, counsel for many underwriters are suggesting that the partners not seek out positions on the board. But if the underwriting firm professes a wish to still do so, the attorney advises them of the multiple dangers, and counsels the necessity, under *BarChris*, to undertake an independent investigation. It is recommended that the partner appointed to seek the directorship be a student of the particular industry of which the issuer is a part, as well as the issuer itself. A few firms stated that under no circumstances would they advise joining the board, unless the company were well-established, mature, and enjoyed a substantial reputation. Even then, the above criteria would apply to the partner. Indemnification of the partner by his underwriting firm was suggested by many counsel.

---

183. See Harris, *BarChris Conference, id.* at 660, for opinion letters of counsel.
184. SEC Admin. Proceeding, File No. 3-1680 (August 26, 1968).

5. The response of counsel to question 17, inquiring into whether if, representing the issuer and an insider, counsel should suggest that the insider obtain other counsel for the offering, was negative, with the exception of only one attorney. These officers and inside directors should stand or fall with the other executives and the issuer's chosen counsel. Due to their inside position they must have a mutuality of trust and confidence. Of course, if they have any doubts, or are aware of any facts which would lead them to doubt, they must either voice these doubts, obtain outside counsel if not satisfied with the answers, or in the alternative, withdraw from the board. Since there is a presumption of almost complete knowledge of the corporate affairs placed upon the insiders no independent investigation was recommended, save under certain circumstances where suspicious facts would lead a prudent man to explore further. (See q. 21.)

6. With respect to the outside director there was again dispute among the various counsel. Most said that he must make at least a nominal investigation consisting of a reading of the registration statement, attending all meetings, reading the major contracts and minutes of meetings missed by the director, and, of course, questioning the officers. A few said that he must go beyond this and make an external investigation as well as a more complete internal verification. Lastly, two attorneys stated that unless the director can show that he was quite familiar with the issuer's business, and had in fact actively participated in directing the company, he had no business being on the board and probably could not sustain his due diligence defense, absent a showing of an extensive investigation. This was particularly emphasized in the case where the director was an attorney or analyst, or possessed some other special skill. (See q. 19.)

The above findings were relatively true when discussing the "new" director as well, although more counsel were of the opinion that they would advise the individual not to join the board in the first instance.[185]

*A. Globus, Indemnification and Insurance*

7. Questions 23, 24, and 25 were directed primarily at the significance of that portion of the *Globus v. Law Research*[186] decision striking an indemnification agreement, at ascertaining

185. This opinion has been expressed previously. *See* Meeker, *BarChris Conference* 573, at 578, *supra* note 105.
186. *Supra* note 177.

the general attitude toward the continuing strength of these agreements, and at gleaning the desirability of obtaining insurance to cover section 11 liability. Since indemnification was not at issue in *BarChris*,[187] and thus not previously discussed, some foundation will be laid in order to give significance to the replies of counsel.

In *Globus*, the court voided an underwriter indemnity agreement holding that indemnity agreements against Securities Act liability violated public policy in that they minimize the penalty for breaching the law, and because the agreements have a tendency to reduce the underwriter's incentive to perform his role of investigation, concomitantly reducing investor protection. This holding was narrowed substantially because the jury, in awarding punitive damages first had to come to a finding of "gross fraud", "wanton dishonesty", or "fraudulent conduct involving a high degree of moral turpitude". Stated in its narrowest terms the holding stands only for the proposition that indemnification will be disallowed where the indemnitee is found guilty of misconduct evincing actual knowledge or reckless disregard of the falsity of the statement made.[188] But there is every indication that the principle will be expanded, either by the SEC or by further court action.

The SEC has shown sweeping opposition to agreements in which a corporation indemnifies its officers, directors, or other controlling persons, holding the same to be void as against public policy;[189] the reason for this being that the stockholders should not be obligated indirectly to reimburse the wrongdoer.[190] The SEC enforces its policy in two ways; one, it may refuse to accelerate the effective date of the registration if there is an indemnity provision,[191] and two, if the situation arises where the

187. *See supra* note 179, and accompanying text.
188. 287 F. Supp. at 199. The Second Circuit was likewise held to the narrower issue and stated, "thus it is important to emphasize at the outset that at this time we consider only the case where the underwriter has committed a sin graver than ordinary negligence." *Supra* note 177 at 98,242.
189. SEC Rule 460, 17 C.F.R. § 230.460 (1969).
190. *See generally* Note, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933,* 72 YALE L.J. 406, 411 (1962).
191. As acceleration is usually crucial in maintaining the distribution time schedule, the SEC's power in this regard is vast. Avoidance of a denial of acceleration can be effectuated if the officers, directors and control persons deliver waivers of the indemnification provision to the corporation or in the alternative, if the corporation agrees in the registration statement that in the event an indemnification claim is lodged against it, that it will submit the public policy question to a court of competent jurisdiction and be bound by the court's determination. SEC Rule 460, *supra* note 189. *See* Note, *Securities Act of*

issuer does not seek acceleration the SEC will withhold approval if the registration statement does not contain a statement acknowledging the SEC's opinion that the indemnification provision is unenforceable.[192] While the SEC has not taken steps to condemn indemnification agreements between the issuer and others, namely the underwriters, there is no indication that they may not do so in the future, since all of these agreements "dilute investor protection by channeling the cost of liability back to a company's stockholders."[193]

But, even if the SEC doesn't act, the indemnification agreement may find itself threatened by further court action. Indeed, Judge McLean has echoed the philosophy of the SEC, in broader context, by stating that the investigatory duties set forth in section 11 charge everyone named within with the responsibility for the truth of the prospectus. Further, while *Globus* spoke to intentional wrongdoing, and was concerned with an action under section 17, *BarChris* and section 11 speak to negligence and as a consequence there need not be a showing of intentional wrong to effectuate the purpose of the section. Thus, if indemnification agreements undermine the effectiveness of section 11 they could very well be voided on a showing of ordinary negligence.[194]

---

*1933-Misleading Prospectus-Directors' Liability Under Section 11-Due Diligence Defense,* 42 TEMP. L.Q. 81, 90 (1968); Kroll, *Some Reflections on Indemnification Provisions and SEC Liability Insuance in the Light of BarChris and Globus,* 24 BUS. LAW. 681, 689 (1969). This agreement is more popularly referred to as the "Johnson & Johnson formula": "Indemnification will not be denied if indemnification is limited to reimbursement for expenses incurred in the successful defense of a suit." Note, *Securities Act of 1933-Misleading Prospectus, id.*

192. 17 C.F.R. § 230.460 note a (1969); Securities Act Release No. 4890, December 20, 1967, p. 21.

193. *See* 82 HARV. L. REV. 951, 959 (1969) and Note, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933, supra* note 190.

No reason is given for the SEC's abstinence regarding underwriters' indemnity agreements, although they stand in the same position as the other defendants under section 11, other than Professor Loss' suggestion that the underwriters "would be unwilling to assume the full risks of section 11, with attendant dangers to the country's economic recovery." *See* 3 LOSS, SECURITIES REGULATION 1835 (1961).

194. The possibility of an expansion of the *Globus* rationale to prohibit indemnification for liability arising from negligent conduct has already been noted. *See generally* Note, *Indemnification of Underwriters, supra* note 193. Also, particular attention should be paid to the language of the Second Circuit, which at several points reflected the philosophy of the 1933 Act. Particularly significant was the recognition of the offensive nature of indemnification agreements when employed to avoid liability under Section 11. The court stated:

> Finally, it has been suggested that indemnification of the underwriter by the issuer is particularly suspect. Although in form the underwriter is reimbursed by the issuer, the recovery ultimately comes out of the pockets of the issuer's stockholders. Many of these stockholders may be the very persons to whom the under-

As an alternative to indemnification, insurance for directors, officers, underwriters and accountants should be considered. While these policies may be offensive to public policy, if the company must bear the entire cost of the premiums, they otherwise should not be objectionable since the ultimate liability costs are not directed back to the stockholders.[195] At the present time the SEC does not prohibit paid insurance covering officers, directors, controlling stockholders, or underwriters, provided that adequate disclosure is made.

From an underwriter standpoint insurance would seem to be more desirable than an indemnification agreement. That indemnification agreements will be held to be void as against public policy is more than just a mere possibility. Also, these agreements are worthless if the issuer becomes bankrupt.

From the issuer's point of view, insurance may be a method of retaining or attracting capable and highly qualified directors and officers who may otherwise not want to assume the risk of liability so vividly portrayed in *BarChris*.

From the investors' standpoint insurance is the best protection against unwarranted loss.

While all of the attorneys polled, save two, were familiar with *Globus*, it was interesting to discover that only a few thought that it would be expanded to outlaw all indemnification

> writer should have been initially liable. The 1933 Act prohibits agreements with purchasers which purport to exempt individuals from liability arising under the act. 15 U.S.C. 77n. . . . The situation before us is at least reminiscent of the evil this section was designed to avoid.

Globus v. Law Research Service, Inc., *supra* note 177 at 98,243.

195. The Securities Act Release No. 4936, ¶ 46(c) (December 9, 1968), states that "no waivers or undertakings need be furnished" with respect to insurance against liability arising under the Act. These insurance policies vary in nature, *see* Kramer, *BarChris Conference,* 24 BUS. LAW. 709 (1969) and, of course, can be very expensive, although they are now more readily available than before. *See* Whitney at 590, Kroll at 685, and Greene at 701, *BarChris Conference,* 24 BUS. LAW. Thus, some provision for pro rata sharing of the premiums amongst all involved in the offering, or a "deductible provision" might be considered. This is also desirable from a public policy point of view as it would be an incentive against being lulled into complacent security by the presence of insurance. In fact, a stiff deductible provision might prove to be necessary, since it would give the incentive to investigate a boost, whereas straight insurance coverage, paid by the company, would have the same tendency to undermine the investigative purpose of section 11 as does the indemnification agreement. Kroll points out at 689, *id.,* that there seems to be no objection to insurance where the director or underwriter purchases the same with his own funds, but also notes that there is a belief that even this would offend the Act. *See* Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Anti-Trust Legislation,* 76 HARV. L. REV. 1403, 1429 (1963).

agreements. From the collective response it appeared that *Globus* had not had a too significant impact upon counsel as a whole.

Nevertheless, the overwhelming majority of those surveyed, who predominantly represented underwriters, stated that insurance would be sought and obtained, if at all possible, notwithstanding a continued practice of utilizing indemnification agreements.

It was the writer's impression that the impetus toward insurance coverage was not so much a result of the *Globus* pronouncement as it was a result of *BarChris*. In other words the attorneys were looking toward insurance as an added protection, perhaps against issuer bankruptcy as in *BarChris*, rather than as a safeguard against an expanded *Globus* decision.

It is suggested that *Globus* be reexamined with the attendant outcome that the desirability of insurance be viewed not totally from a *BarChris* vantage point, but also with a jaundiced eye toward the continued vitality of indemnification agreements.

The end result may be that many financially unstable or unseasoned companies may not be able to obtain public financing in the event that insurance coverage is denied or too expensive. Perhaps this is the best result, for if it is too risky for an insurance company then it may be too risky for the public. This is not to say that the investor ought not to be allowed to play the role of a fool in season; it is to say that they ought to be protected in the event that they are damaged by misrepresentation, fraud, or negligence. It is not a highly unlikely possibility that in a given case the issuer may be bankrupt, with the underwriters and others involved under section 11 devoid of sufficient funds to compensate the harmed investors.

(Indeed, in *BarChris*, both the issuer and one of the underwriters were in bankruptcy.) In this situation compensation would be forthcoming through insurance coverage; thus the ultimate beneficiary, the investing public, is fully protected.

## CONCLUSION

The Sixties have witnessed what seems to be a new era of investor protection, for not only has there been an expansion of common law notions concerning negligence and misrepresentation such as evidenced in *Fisher v. Kletz*,[196] and *Rush Factors*,

196. *Supra* note 167.

*Inc. v. Levin*,[197] but also a somewhat revolutionary expansion in the number of civil remedial vehicles afforded the "defrauded" investor in the 1933 and 1934 Acts has taken place through such cases as *SEC v. Texas Gulf Sulphur Co.*,[198] *Ellis v. Carter*,[199] *J.I. Case v. Borak*,[200] and of course, *Globus.* All of these cases have implied remedies through traditionally "criminal" sections.

The significance of this trend finds import not so much in the innovative ingenuity of plaintiffs' counsel in utilizing criminal sections to find implied civil remedy as it does in highlighting the question as to why resort is taken to these alternate routes in the first place. Perhaps the answer lies somewhere between necessity on the one hand, and desirability on the other.

But *BarChris* has awakened section 11, and it may prove to have been a sleeping giant now that it has definition and substance. Yet, one cannot help wonder whether its teeth should not be sharpened to bring order to the maelstrom that is called civil liability under the Acts. The short statute of limitations, the compensatory limitations, and the threat of a security for costs no doubt have driven section 11 plaintiffs to other sections of both Acts as witnessed by *Globus*, *Fischman v. Raytheon Mfg. Co.*,[201] and *Rosen v. Bergman*,[202] and judges, commiserating with these plaintiffs, have been prone to lend benediction to the transfers. A continued expansion of section 17(a) and Rule 10b-5 in this direction would, it seems, be clearly undesirable. Thus, some legislative thought should be given to a revamping of some of these features of section 11, as well as to very necessary further clarification of some of the more perplexing problems raised by *BarChris* and inherent in the section.

197. *Id.*
198. 401 F.2d 833 (2d Cir. 1968).
199. 291 F.2d 270 (9th Cir. 1961).
200. 377 U.S. 426 (1964).
201. 188 F.2d 783, 787 (2d Cir. 1951).
202. 40 F.R.D. 19 (S.D.N.Y. 1966).